PRACTICAL HINTS FOR INVESTORS

BARRON'S FINANCIAL LIBRARY

Buying a Bond, *by Philip L. Carret*

The Stock Market Barometer, *by William P. Hamilton*

National Government Loans, *by William L. Raymond*

Investing in Purchasing Power, *by Kenneth S. Van Strum*

Investing for a Widow, *by Walker Van Riper and others*

Practical Hints for Investors, *by Walker Van Riper*

PRACTICAL HINTS FOR INVESTORS

BY

WALKER VAN RIPER

BARRON'S

The National Financial Weekly

BOSTON NEW YORK PHILADELPHIA

1926

Preface

DURING the course of many years' experience in the investment business and several in banking, I have come into contact with the financial problems of men and women in all walks of life; and I have had an opportunity to observe their common mistakes, their difficulties, their successes and their failures. In these times in which we live, the facilities for thrift and investment are more trustworthy and more widely accessible than has ever been the case before, in any country; on the other hand, the agencies of unsound finance flourish with unprecedented vigor. It is the purpose of this book to point the way to the former and to show how to recognize and avoid the latter.

I have explained exactly what steps the beginning investor should take in order to proceed with safety; I have shown how investments are to be analyzed, what to study, where to find the necessary information, whom to trust and whom not. In the closing chapters, speculation and investment are distinguished and elucidated, and the differences between investment in bonds and in stocks are treated.

Throughout the book I have had small investors particularly in mind—women as well as men. The modern financial organization provides every facility and service for women which it offers to men; and women, by following the

directions given in this book, may handle their own investments safely.

Few people realize how, in recent years, the small investor has come to occupy an exceedingly important position in the American economic and financial system. Within ten years the numbers of bondholders and stockholders in this country have multiplied manyfold and savings depositors have increased enormously. The Liberty Loan campaigns are generally assigned as a reason. Suddenly the largest banks and the largest bond dealers have awakened to the fact that the "little fellow" is well worth cultivating. The many advantages in this situation for the "little fellow" I have endeavored to show.

But I have not been unmindful of the problems of the large investor. In several ways I believe his methods may be improved; and he commonly subscribes to a number of economic fallacies on which I have endeavored to throw light.

W. V. R.

June, 1926.

CONTENTS

Chapter I

The Primary Investment

Financial Problem of Average Man and Woman —The First Investment — Characteristics and Advantages of Savings Account — Federal Reserve System—Age and Size of Bank Important —Why Largest Banks Desire Accounts of Small Depositors — No Basis for Timidity — Details Concerning Savings Accounts—Recommendation

THE financial problem of the average man (who is often, by the way, a woman) may be stated in very simple terms,—first, to save money; second, *to keep it saved.*

It is with the second part of the problem that this little book is particularly concerned. As for the first, I make this statement, which I shall not stop to prove but which I *could* prove to the satisfaction of the most skeptical: in these United States, at the beginning of the second quarter of the twentieth century, it is easier to save money and a greater proportion of the population is doing so than has ever been the case at any time, anywhere, in history.

But as to whether we are making a record at keeping money saved, I am not so sure. I do know that a great many of those who try it fail; and yet I am equally sure that the facilities for doing the thing are better and are more easily accessible than ever at any time before.

Almost everyone starts to save in a small way,

and the few who succeed in keeping their savings saved do so by *gradual accumulation, careful study of the different kinds of investment, and by the exercise of prudence and self-control.*

The general plan that I shall follow is to take up the simplest form of investment first, and then, in order, the more difficult and complicated forms. And this is the plan I recommend to you; that is, that you take up one thing at a time, study it carefully, and invest in that field as far as your judgment dictates before you graduate into the next class. How to do the necessary studying, on what to base your judgments, and where to find the material are part of what I have to tell you.

The First Investment

In point of time, and, for almost everybody, in point of general importance, the first investment is the savings account. As to the amount that may be invested, the savings account is the most *flexible* of all investments; in a proper bank it is thoroughly *safe;* it is perfectly *simple* and easy to understand; it cannot be lost or stolen; the interest accrues and is compounded automatically; it may be quickly turned into cash; it *does not fluctuate* in value; and, considering all these advantages, it pays a good income.

The fundamental purpose of investment is *protection* of one's family and one's self. In the first place, protection against the ordinary vicissitudes of life—sickness, accident, lack of employment; in the second place, protection against the

declining earning power of old age. No other investment meets the first of these objects so fully as the savings account. It is the best form of emergency fund. In any investment plan, therefore, it has a primary place. I advise that, for the average person, the savings account should be built up to $1,000 before any other investment is undertaken, and then should ever afterwards be kept at or above this amount.

The Magic of Compound Interest

Over a period of time this will be a more profitable investment than at first appears. 3½% seems a low rate of interest, but 3½% compounded semi-annually carries a magic which never fails to surprise me, accustomed as I am to this sort of arithmetic. The best way of illustrating this is to show you the figures, and I therefore append a little table which does this.

Growth of a Savings Account of $10 per Month at 3½% Compounded Semi-Annually

In twenty years the actual amount deposited is $2,400; the interest is $1,068.86; and the total $3,468.86.

Period	*Deposits*	*Interest*	*Total*
One year	$120.00	$2.28	$122.28
Two years	240.00	8.91	248.91
Three years	360.00	19.96	379.96
Four years	480.00	35.63	515.63
Five years	600.00	56.10	656.10
Six years	720.00	81.56	801.56
Seven years	840.00	112.13	952.13
Eight years	960.00	148.02	1108.02

Period	*Deposits*	*Interest*	*Total*
Nine years	$1080.00	$189.44	$1269.44
Ten years	1200.00	236.54	1436.54
Eleven years	1320.00	289.53	1609.53
Twelve years	1440.00	348.63	1788.63
Thirteen years	1560.00	414.05	1974.05
Fourteen years	1680.00	486.03	2166.03
Fifteen years	1800.00	564.79	2364.79
Sixteen years	1920.00	650.54	2570.54
Seventeen years	2040.00	743.58	2783.58
Eighteen years	2160.00	844.12	3004.12
Nineteen years	2280.00	952.46	3232.46
Twenty years	2400.00	1068.86	3468.86

Not all banks pay 3½% on savings accounts, but this figure has been used in the table as it is half-way between 3%, the lowest rate paid by large banks, and 4%, the top rate. As a means of comparing the results of compound interest the following examples are interesting: at 3% compounded semi-annually money doubles in 23 years and 3 months; at 3½%, in a little less than 20 years; and at 4%, in 17 years and 6 months.

In the succeeding chapters which treat of other forms of investment, I shall follow the plan of referring to books, periodicals and other sources of material which may be consulted for further information on the subjects under discussion. The savings account, however, is so simple that it may be fully considered in a few paragraphs.

As with all investments, safety of principal must be the first thought. Bank failures, we may be thankful, are no longer very large in this country; that is, *large* in the total amount involved; the *number* of small bank failures is

shamefully large. The strength and safety of the banking situation has gained tremendously with the years since the Civil War when the national banking system was created. And one who is not a thorough-going student of finance can hardly appreciate how greatly this system was fortified by the Federal Reserve Act. Sir Edward Holden, the great British financier, recently congratulated the Federal Reserve Board and the bankers of America on having created a banking system which "surpasses in strength and excellence any other banking system in the world."

The Federal Reserve System in effect is composed of twelve super-banks, all closely associated and under strict government control. These twelve super-banks, the Federal Reserve Banks, receive deposits from and make loans to member banks of the Federal Reserve System only. By law *all* national banks are required to join the system; state banks and trust companies *may* join at their option. The system was designed as a preventure of panics and to make banking safer.

Bank failures, it is true, still occur in this country. In the banking business, as in other businesses, it takes a certain *time* for an institution to become securely established; and, moreover, a certain *size* must be attained in order to distribute the business risk sufficiently to make operations thoroughly safe. Anyone who takes the trouble to examine the statistics on the subject which are to be found in the annual reports of the comptroller of the currency will be surprised to find

how long it has been since a really large national bank has failed anywhere in this country. To be specific, no national bank with deposits of $20,000,000 or upwards has *ever* failed since the establishment of the national banking system in 1863.

The First and Most Important Step in Finance

As you read through this little book you will find that I have emphasized again and again that the *first,* the *easiest,* the *surest,* the most important step which the novice may take in any of his financial dealings is the selection of the *best possible* bank, insurance company or bond dealer.

This is the most direct and effective way to eliminate risk. And it is something which everyone, no matter how small his knowledge or experience, can do successfully. Hence I have taken particular care to make my directions for the selection of the various financial agencies definite and clear.

As for the selection of a bank, I have already indicated that membership in the Federal Reserve System, size and age are the important considerations. Of course the largest and oldest banks are in the largest cities. There is no absolute requirement, however, in either age or size and in any locality there is often no choice among several banks. In the last analysis, selection is a matter of judgment. What has been said indicates along what lines judgment should operate; and this applies with equal force in either large or small cities. The aim must be simply to select

the best bank available, and it is plain that there are no great difficulties involved in doing this.

No one need feel the least timidity about going in to open a savings account with a large national bank even though the initial deposit be small. When such a bank states that it will accept small savings accounts it does so in the belief, founded on experience, that the average person *can* and *will* save money when once the start has been made. The very largest national bank in the United States actively solicits small savings accounts, and it is safe to say they are welcome in *all* large banks.

Economic and Financial Importance of the "Little Fellow"

I can remember a time when it was considered unethical for a bank to advertise and when practically all large banks refused to take small accounts. Even before the war, however, it was apparent that these conditions were changing. And the experiences of the Liberty Loan campaigns, when the total subscriptions of the small subscribers compared so favorably with those of the large, convinced everybody of the importance of the "little fellow" in finance. The result is that in these days the small savings depositor and the small investor are welcome everywhere.

It has often been said that one of the reasons why the promoters of fraudulent and risky financial schemes are so successful in this country is because the man of small means is timid about doing business with the large bank and the large

bond dealer; and hence falls an easy prey to the stock salesman who shrewdly plays upon this attitude of mind.

There is no longer the slightest basis for such timidity. In addition to what has been said, another proof of this fact is that practically all the largest banks and bond dealers are nowadays spending good-sized amounts in advertising—this is obvious to all newspaper readers. And nearly all this advertising is directed at the "little fellow." The reason is that we now definitely know that small savings and small investments are of the greatest economic and financial importance.

In regard to the interest on savings accounts, there are one or two points to be explained. The conditions under which savings accounts are accepted and the rules governing the payment of interest vary slightly throughout the country, as does the interest rate paid on savings accounts. These rules you will generally find printed in the savings pass-book. I can think of no instances now where it is not the practice to compound the interest; though the periods of compounding vary, being sometimes annual, sometimes monthly, but most often semi-annual.

Explanation of Compound Interest

Compound interest provides for interest upon interest; that is, you make a deposit; at the end of the stated period the interest on this deposit is credited to your account; in the second period interest is figured and credited not only on the

original deposit but also on the interest earned in the first period; in the third period, interest is figured on the original deposit plus the interest credited in the first and second periods, and so on. Thus the interest earned becomes, at the end of each period, a part of the principal and itself earns interest.

If you follow my recommendation, a savings account will be your first investment, and you will keep one all your life, no matter what other additional forms of investment you may adopt as time goes on. Over a long period compounding becomes very important. Thus $1,000 at 3½% simple interest for 20 years becomes $1,700, but at 3½% compounded semi-annually, becomes $2,001.60.

In a preceding paragraph I made the statement that, considering the other advantages incident to the savings-account investment, it pays a very good income, and I now wish to emphasize this point again. You must bear this in mind, that in investment matters, as in other business transactions, you should expect to pay value for what you get. Investments are not always to be made for income alone. You will need to remember this, particularly when it comes time to take up such subjects as insurance, home ownership and tax-exempt securities.

Compound Interest from the Banker's Standpoint

From the banker's standpoint, also, 3½%

seems a good stiff rate to pay on deposits. Sound banking practice, as well as the banking laws, requires that these deposits be invested only in securities of the highest character—such as afford not only the highest degree of safety but the highest degree of convertibility into cash as well. As you will see when you come to examine these matters for yourself, the average yield of such investments is not very much higher than the rate that must be paid out. And, surprising as it may be to the layman, banks very frequently have large sums out at lower rates than they are paying on savings accounts. The wise banker knows that interest rates are not made to his order, but are determined by economic forces over which he has no control. Experience has taught him the advisability of investing in certain fields, hence he goes right along and does this, no matter what the rates. There are often times when the yield on short-term government paper, acceptances, or call loans is below 3½%; yet all large banks continually have large holdings of these types of investment, which are desirable not only for their great safety but mainly because they are instantly convertible into cash.

The Reason Behind Several Rules

In order to handle savings accounts profitably on a very narrow margin of profit, banks simply must reduce the overhead expenses in this department to a minimum, and this is the reason behind

several of the savings-account rules which might at first be difficult to understand.

The cost of handling an account is largely proportional to the number of "items"; that is, the number of checks and deposits, as these, in turn, determine the amount of bookkeeping necessary. On the average, this cost is more than ten times as great for a checking account as for a savings account of the same size. This enormous difference is due to the fact that checks against savings accounts are relatively few and far between. And the necessity for this is the reason for those savings-account rules that penalize checking — the rule that withdrawals are subtracted from the first deposit and the rule that interest is paid only on full monthly periods.

The task of figuring interest on savings accounts is a big one but, in order to eliminate errors, it is, in most banks, done twice; that is, interest on each account is figured by one man and then checked by another; hence mistakes are very rare. And it is not at all uncommon for banks to have upwards of ten thousand separate savings accounts.

At the end of each interest period the interest accrued is promptly credited to each depositor on the books of the bank. Many depositors have the idea that interest must be entered in their pass-books or they will not get it; hence, at the end of every interest period, the banks are crowded with savings depositors, who obviously cannot all be served at once. This rush is a hard-

ship on bank clerks and depositors alike. You may save this bother by understanding that you receive your interest just the same, even if it is never entered in your pass-book; because it has been credited to your account on the books of the bank as soon as earned, and may be noted in your pass-book at any convenient time thereafter.

An Investment Which Cannot Be Lost or Stolen

One of the advantages of a savings account which I have mentioned but not explained is that it cannot be lost or stolen. You should take care not to lose your savings pass-book, and it is wise to keep it, together with your other valuable papers, in a safe-deposit box; but if you do lose it, or it is stolen or destroyed, the matter is not beyond remedy, as you may see by reading the rules in the pass-book relating to this matter. Another thing, if your pass-book is stolen and the thief forges your signature and is successful in drawing money from your account, the bank must stand the loss, not the depositor. Losses of this general character are greater in the banking business than is generally realized. Insurance is carried against them and its cost is one of the factors in the expense of doing business.

In closing this chapter on the savings account let me reiterate—I consider this the *primary* investment. It is my experience and observation that the very first and most important and urgent thing you must do with your first savings is to

provide a rainy-day fund, a protection against emergencies. Everyone needs this, and, no matter how large or how diversified your investments may ultimately grow to be, this first investment, your savings account, should always be maintained. For the person of moderate responsibilities and in moderate circumstances I recommend that the savings account be kept at a point rather over than under $1,000. For many of my readers this will be far too small; for few will it be too large. Use your best judgment; set a figure for your savings account and keep it there. Never draw it down below this amount except for emergencies — under no circumstances for current expenses or in order to make another investment.

CHAPTER II

Life Insurance

Necessity of Life Insurance—Two Great Risks — Requirements for Insurance at a Maximum Early in Life — Modes of Settlement — Policy Loans—Investment Possibilities—Selecting the Insurance Company

THERE are two good reasons for introducing this chapter on life insurance into a book on investment. First, insurance is a financial undertaking of greater importance to the average person than investment in stocks and bonds, and should also come first in point of time. And, second, there are certain forms of insurance which deserve very serious consideration on their merits as investments alone. I have nowhere seen the necessity of life insurance so vividly stated as in the following paragraphs which are quoted from a publication of one of the large insurance companies; let the reader also note that they are a pointed commentary on the inability of the average man to make successful investments.

"If you take one hundred average men age twenty-five, healthy, of good mental and physical character, but with no means of support except their heads and hands, and watch them as they swing down in front of the grandstand on their successive ten-year laps, you will find that this is what happens to them:

Age 35. Five have died; ten have become wealthy; ten are in good circumstances; forty

have moderate resources; thirty-five have not improved.

Age 45. Eleven have died, making a total of sixteen; all but three of those who had made and saved money have by this time lost all their accumulations; sixty-six are still working and self-supporting, but without any other resources; fifteen, through illness, accident or reverses, are no longer self-supporting—a few of these still earn something, but not sufficient so that they may be considered self-supporting cases.

Age 55. Four more have died; twenty are now dead. Of the others, one has become very rich; three are in good circumstances; forty-six are still working for a living, not having been able to accumulate anything; thirty are now more or less dependent on their children, relatives, or charity for support—some of these may be able to do some kinds of light work, but they are replaced by younger men.

Age 65. Sixteen have died during this period, making a total of thirty-six out of the one hundred. Of the remaining, one is still rich, four are wealthy, one of those who lost everything before forty-five has regained hold and become wealthy; only six are still self-supporting, but are compelled to work for a living; the others, fifty-three, are dependent on children, relatives, or charity.

Age 75. Death has claimed sixty-three, sixty of whom left no estates; two of the five rich men have lost out; the rest are dependent."

This striking record brings out the two great life risks which exist for every individual—*premature* death and the failure to provide and *keep* funds for old age. The primary function of life

insurance is protection against premature death. In this last sentence the word *premature* needs emphasis because it includes a very important idea, to-wit, that the requirement for life insurance is at its maximum early in life (the risk of dying prematurely being greater the younger you are), when great and lasting responsibilities have been or will soon be undertaken, when prospects are bright, income is on the up-grade and accumulation has not progressed very far.

What Adequate Insurance Really Means

To illustrate this point which is very frequently overlooked, consider the case of a young man twenty-five years old with a wife and two children. He has bought a home, but still owes half of the purchase price. Adequate insurance in his case must contemplate a sum the annual income of which will support the wife for her lifetime, educate the children and care for them until their maturity. And it would be the part of wisdom to have enough additional insurance to take up the mortgage on the home. At age fifty, the insurance requirements of this same man are very much smaller. The children are now grown, probably the home is clear of debt, and there may be other assets. Adequate insurance now means only enough to care for the wife for the balance of her lifetime. As she now has a shorter time to live by twenty-five years than in the first case, this amount is very much reduced.

It is the young man, then, who needs to pay

particular attention to this matter. Moreover, insurance is cheaper for the young man. And finally, (it is impossible to put this too strongly) the young man *must* purchase insurance at the earliest possible opportunity (not waiting for marriage, or until he needs it—these are fair certainties—or putting it off for any reason whatever) because the loss of youthful health may at any time take away the possibility of ever getting insurance at all. Health is a prerequisite for insurance. The risk of its loss is far greater than the risk of premature death. It follows therefore that, if the individual must, as a matter of good sense and good conscience, insure against death, it is of the very greatest urgency that he do so at the earliest possible time.

Careful Analysis of Individual Requirements Necessary

Out of modern competitive conditions there have developed varieties and forms of life insurance to meet almost every conceivable requirement. It is therefore an intelligent preliminary step to the purchase of insurance for the individual to devote some sober consideration to an analysis of what his requirements for insurance actually are. These are determined by the nature and extent of present and prospective family and business responsibilities; in this latter field the possibilities and advantages of life insurance are coming more and more to be appreciated. It must be understood that the individual's insurance re-

quirements are likely to change materially several times, and the insurance carried should be adjusted accordingly.

The amount of insurance necessary is an important consideration and very often this is incorrectly analyzed in a way which sets the figure much too low. I refer to those cases where it is the permanent loss of the family income, due to the death of the family's head, which is to be insured against. Here, if the mind's eye rests upon the lump sum of cash payable at death, rather than on the amount of annual income which should be provided, too little insurance is likely to be the result. Ten thousand dollars is a large sum of money, but, if invested at 6%, it will yield a monthly income of only fifty dollars.

How to Provide for the Effective Use of Insurance

A large life insurance company made an extended investigation of its settlements of $5,000 or more over a long period and found that, after seven years from the date of receiving payment, ninety percent. of the beneficiaries had either lost or spent the entire amount received. This emphasizes the necessity of looking beyond the payment of insurance and making provision for its most effective use. Formerly all settlements were made in lump-sum cash payments. Under certain circumstances this should always be the preferred mode. But probably in the great majority of cases this is not so; and modern insurance policies

give the insured the option of several methods of settlement. Obviously the chances of successful and safe investment are all against a widow, inexperienced in business, who receives a large cash payment. Some form of installment or annuity payments, however, would make this situation absolutely safe. This is a very important feature and the insured should always take pains to see that his policy meets his requirements.

Policies are very much shorter than they used to be. The language is less technical and easier to understand. The provisions are perfectly definite and mean what they say. Therefore it behooves everyone to read his policy carefully and make sure that he understands its provisions and that those provisions meet his needs. Any doubtful points may easily be cleared up by writing the company or asking the agent.

The Prudent Man and the Policy Loan

Most life insurance policies have a loan value; that is, the insurance company agrees at any time, on application, to loan the insured a certain sum on his policy. This is a privilege which the prudent man will reserve for one situation only; and that is, to meet his insurance premiums in time of distress. A policy loan is a policy mortgage. The man whose respect for his home and his family would make him reluctant to mortgage his home should be ten times more loath to mortgage his insurance. This should never be done except in

case of absolute necessity and only to protect the insurance itself.

The record of the quick dissipation of insurance payments mentioned above not only shows the necessity of selecting a preventive mode of settlement but is a very keen and truthful indication of the inability of the average man and woman to make safe investments. There is no dodging the fact that the qualities of prudence, self-restraint and intelligence, without which successful investment in bonds and stocks is absolutely impossible, are possessed by only a very small minority of those who make the attempt. A great many people would be better off if they limited their financial operations entirely to savings accounts and insurance policies. That so many ultimately make financial failures is unquestionably due, not so much to lack of thrift or to total savings too small to count, but to unwise employment of savings—the failure to preserve accumulations when made.

Investment Possibilities of Insurance

The excellent investment possibilities of insurance are not widely enough appreciated. For persons in many circumstances, endowment insurance and annuities represent absolutely ideal investments. A man or woman, well along in years, and without dependents, for illustration, may buy an annuity, which is a certain income for life, and receive a greater return than is possible in any other way. It may be said of insurance invest-

ments, that they are thoroughly safe; they are simple and easy to understand; they require no study or care; and as with all insurance, the necessity of paying premiums periodically and promptly is a very important aid to thrift.

It is solely in the matter of the rate of interest or income to be obtained that investment in stocks, bonds and mortgages is more advantageous than insurance. One must remember, however, that the risks are greater, that more care, study and time are required, that much self-restraint and prudence are necessary, and that a great many people fail in the attempt to make profitable stock and bond investments. Given the right qualities of character, however, the thing is perfectly possible for anyone, as may be seen from a perusal of the chapters to come.

As between insurance companies, one may well bear this in mind: mere size, both with banks and with insurance companies, is highly significant. Size means, first of all, a wide distribution of the risks; that is to say, a higher factor of safety. A bank or insurance company with five thousand separate items of investment obviously has far less risk of serious loss than one with a hundred items. Size also is significant of long experience and successful and conservative management; because both banks and insurance companies, in the nature of things, are of slow growth. Finally, size indicates the patronage, approval and favorable judgment of numbers of depositors or policy holders. Size, however, is not an absolutely

essential requirement in selecting an insurance company as it is with a bank. Broadly speaking, it is safe to do business with practically any "old line" life insurance company. Professor Huebner, an authority, was recently quoted as saying that there has probably not been a dollar lost to a single policy-holder in the United States in any life insurance company in the last thirty years.

There are small but important differences in the rates and contracts offered by different companies and these should be considered in making a choice. Often there is a strong local company which deserves patronage.

CHAPTER III

Investment in a Home

Judging the Home as an Investment—Buying and Building—General Considerations—Character of Neighborhood—Public Utilities—Public Improvements—Legal Phases—Financing—Mortgage Investment—Income-Paying Properties

MORE than one philosopher has commented on the fact that the desire to own things is a deep-seated and universal human instinct. It is thought that the type of organization which society in its higher stages tends everywhere to adopt is determined by this instinct which is individualistic, acquisitive, dominating. Except for it, some other kind of organization, such as socialism, might be possible.

The satisfactions which are derived from owning a home are not only in answer to this instinct but are æsthetic, social, creative, and bound up with family life. The subject is a favorite one for the poets and moralists. It is to be considered here, however, only from the business standpoint.

A home may have everything in the way of attractiveness, neighbors, location and comforts, and yet be a poor investment; on the other hand, it may have every desirable quality and at the same time be an excellent investment. Of the two situations, the latter is much the more desirable. How is one to make the investment test?

A Fundamental Economic Principle

In a later chapter I will explain how to approach the problem of estimating the value of a property which is the basis of the issuance of investment securities. The method is founded on the important economic concept that all value is derived from income; that is, that it is the capacity of a property to produce income or earnings which determines its value. It is a common mistake to look at this matter the other way round, and hold that value determines income. But in fact, with a house, for example, it is rental value which fixes sale value, and not sale value, rental value.

It is plain, therefore, that, if the fair rental value of a house is sufficient to cover taxes, depreciation, upkeep and interest on cost, it is a good investment. For a house costing $5,000, taxes, depreciation, and upkeep ought, on the average, to be covered by $300 per annum, and six percent. on cost would amount to $300 additional, making a total of $600 per annum, or $50 per month. We may say, therefore, that, if it would cost $50 or more per month to rent such a house, it would be a good investment at $5,000.

The Two Ways of Acquiring a Home

A home may be acquired in one of two ways: by building or by the purchase of a house already built.

There is an advantage in *buying* over *building* in that the amount of money involved is a per-

fectly definite sum and the purchaser may examine objectively and in detail the property under consideration. It is comparatively easy, therefore, to judge whether it may properly be called an investment or not. Whether one buys or builds, the general character of the house, its size, location, the amount of ground, and the neighborhood are to be determined by individual preferences and the family requirements.

In both cases the following points require careful attention. A house should fit the general character of the neighborhood in which it is located. It is a commonplace that the owner of a $15,000 house in a $5,000 neighborhood will never be able to get his money out.

In the modern city the desirabilities of different sections tend to rise or fall; it is necessary, therefore, to guard against buying property in a section where values are depreciating.

The services of the various public utilities—street cars, electricity, gas, telephone—and the accessibility of schools must be carefully surveyed.

Public improvements such as sewers, sidewalks, paved streets and alleys, curbs and gutters, are very important.

The Dynamite in Special Assessments

If these improvements have already been made, they increase property values; if not, they constitute a liability. In almost all communities these things are financed by special assessment taxes levied against the property benefited. "It is sur-

prising," writes Clinton H. Blake, Jr. in *Acquiring a Home,* a very valuable book on the legal phases of this subject, "how many capable business men, not accustomed to dealing with real property, are wholly or largely ignorant of this subject. To them the words, *special assessments,* have merely a vaguely familiar sound, but no special connotation. Certainly they do not realize how much dynamite they may contain, or how expensive they may prove to be."

There is much satisfaction to be obtained from planning and building a home to suit individual preferences and requirements. From the investment standpoint, as indicated above, this complicates matters somewhat, as it is difficult to make estimates of cost sufficiently accurate. The conservative builder will eliminate from his plans any notions which are very unusual or idiosyncratic, as these may adversely affect future sale value. It is my observation that the services of thoroughly competent architects and contractors are well worth while.

The legal phases of our subject are far more important than the layman is likely to realize. The advice of a lawyer is almost essential. The contract of sale, the title, the deed, and all contracts with architects and builders require such advice. The title, of course, is of fundamental importance in any real estate purchase. Where it is possible to obtain a guarantee of title or policy of title insurance from a responsible title insur-

ance company this course has much to recommend it.

Financing the Purchase of a Home

As to financing the acquisition of a home, it is my belief that the man who saves up the entire amount necessary before he makes his purchase and then pays cash in full is acting with the greatest financial wisdom. In a later chapter you will find the reasons why it is bad practice to borrow money to buy stocks and bonds. In fact, it is my observation that, generally speaking, the prudent man does not go into debt. Moreover, I have found that the cash purchaser, much more frequently than the credit purchaser, is likely to be careful, thorough, and sound in forming his judgment; and hence is much more likely to get full value for his money.

This country is so rich and its financial organization is so intensively cultivated that credit is freely available for almost every conceivable purpose. When rightly employed, this is, of course, of tremendous advantage; but it is often misused.

Whenever I see the purchaser of a house paying a high price because the terms of payment are attractive, I am reminded of that old story about the hilarious house-party on the banks of the Hudson. One member said he felt so good he believed he could jump across the river. A second said, "I'll bet you a million dollars to a dollar you can't." The first planked down a

dollar on the table, ran out of the house, down to the dock and jumped into the stream. They fished him out, and someone asked, "You crazy fool, why did you do that?" He replied, "The odds were so attractive, I couldn't resist them."

The president of the American Banker's Association recently said, "Buy your own home, but be able to pay at least thirty percent. down." As indicated above, it is my judgment that the soundest course is to save up the necessary money first and pay all cash. At the same time, I realize that it is generally considered within the limits of sound finance to use credit in buying a home to a substantial extent. I should not go so high as seventy percent.; it seems to me that the conservative upper limit is in the neighborhood of half.

Most of my experience in this field has been as a lender to small borrowers. As a general rule, it is safe to say that the interest rate and other expenses in connection with a real estate loan grow larger as the percentage of property valuation represented by the loan moves upward. In other words, it will cost more to borrow seventy percent. than fifty. There is generally a good supply of funds in the loan market available at low rates for small real estate mortgages on an ultra-conservative basis.

Paying Off Debts Always a Good Investment

For one who has made use of credit by placing a mortgage on his home, I have a bit of financial advice which is incontrovertibly sound: the best

investment you can possibly make is your own outstanding notes; that is, by paying off the mortgage. One who is in debt for any purpose whatever should get out of debt before making any other investment.

With this in mind it is wise to arrange, when the mortgage papers are being drawn, for the privilege of making payments on account of principal at stated intervals. One who is borrowing on a very conservative basis may generally get this privilege without cost or penalty; but, for the other kind of borrower, the expense may be considerable. I recently examined an installment-loan contract in wide use in which the net interest cost figured out at practically ten percent. per annum. That anyone should ever borrow money at this rate seems to me highly unwise.

Mortgages as Investments

Discussion of the use of credit in buying a home leads naturally to the viewpoint of the investor who lends money on mortgage security. This is one of the oldest forms of investment, and one of the safest and easiest to understand. Any man or woman who has gained some knowledge of real estate values by purchasing a home and who has come to understand the principles of the mortgage may enter this field of investment with considerable assurance.

It is necessary to make oneself a sound judge of values by watching and comparing the prices at which various properties are sold. It is wise

always to have an attorney draw the papers, and it is absolutely essential either to have the title to mortgaged property guaranteed or to have a competent attorney's opinion on it. The risk in making loans on real estate is less the smaller the properties, as there is less risk of making serious mistakes as to values. Loans up to sixty percent. of valuation are at about the upper limit of safety. It is necessary for the lender to see to it that fire insurance on mortgaged property is kept up and that taxes are promptly paid.

The careful person, who is willing to give the necessary attention to the foregoing details and who has the time to go out and look for loans, will find this an excellent field. What has been said refers to mortgages on medium-priced homes where the investor makes the entire loan and holds all the papers himself. Real estate bond issues on large properties are in a totally different investment class and are to be judged by the methods which are explained in later chapters.

In most cities there are responsible agencies which make a specialty of handling real estate loans for investors. Some trust companies and banks have departments which do this. Often the most trustworthy places to purchase loans are the offices of real estate agents; and in many cities there are mortgage-loan companies which handle no other business. Some of these companies guarantee their loans, others have principal and interest insured by insurance companies—these forms of protection are valuable to the extent that the

guaranteeing and insuring companies are conservative and financially responsible. There is probably no way by which loans which are fundamentally unsound can be made safe investments. This the investor must always bear in mind.

If one is to rely entirely upon the judgment of the agency through which real estate loans are purchased (a practice which I do not recommend), it is obviously necessary to use great care in the selection of the agency; of course, it is wise to use such care in any event. The next chapter explains how to select a bond dealer and exactly the same methods should be pursued here. In a word, do not fail to get your banker's advice in this matter.

Income-Paying Real Estate

The ownership of income-paying real estate affords a type of investment in which many men and women of moderate means are quite successful.

The first requirement for success is that one be a keen judge of values. But this is not all; the duties and cares of a landlord are by no means light. Those who would make the best success in this field must have the time and the patience to attend to a multitude of details, together with the ability to get along well with tenants. Women who have the artistic sense to make interior decorations attractive at small cost and men who use tools and can make small repairs themselves have obvious advantages. First-class workmen are

always an economy on jobs of importance, but there are many small things on which a landlord may economize considerably if he can care for them himself.

Vacant land and all kinds of unproductive property are to be regarded as speculations, not as investments. This is fully explained in a later chapter.

Quoting from *Investment and Speculation,* "Real estate has, almost from time immemorial, been a favorite medium of speculation and it will probably have to be admitted, generally speaking, that it has proven to be exceedingly hazardous."

Intelligent and painstaking personal attention is the great factor which makes for success in the the investment of funds in real estate mortgages and income-paying properties. Some of the details may be handled and considerable helpful service may be obtained from a reliable real estate agent or broker.

It is necessary to have one who is not only trustworthy but thoroughly capable and intelligent. Personal qualities count here almost as much as with the bond dealer. The selection should be made on your banker's recommendation, and what is said in the next chapter on the selection of a bond dealer applies to this case also.

Chapter IV

Where to Buy Bonds

The First Step for the Bond Buyer—Men and Women of Small Means Welcome as Customers—How to Select the Bond Dealer—Only the Opinions of Bankers and Bond Dealers of Value—A Good Rule to Transact All Business in Bond Dealer's Office—Advantages Offered by First-Class Investment Dealer

WE are now ready to consider bonds as investments. As compared with the kinds of investment so far discussed, bonds constitute a type which is considerably more complicated, where both the risk and the return are somewhat greater, and where more care, judgment and study are required.

The first step for the beginning bond buyer, or for the old bond buyer who wishes to improve his methods, consists in the *selection of the very best bond dealer available.* How to do this, the importance of it, and the many advantages to be derived from it are all explained in this chapter.

I have already stated that bankers and bond dealers are now thoroughly alive to the very great economic and financial importance of the small savings depositor and the small investor. The greatest banks and the largest bond dealers earnestly desire the business of the "little fellow" and they are prepared to give him every attention and every service which is available for the man of wealth. There is no longer the slightest reason,

therefore, why any man or woman should not have the great advantages which may be had by dealing with the best banks and the best bond dealers.

The Most Valuable Advice in This Book

To the outsider, particularly to the person with small experience in financial affairs, all bankers and all bond dealers are likely to look much alike; but the insider appreciates that, in finance as in other human activities, there is a wide difference in the capability, energy, trustworthiness and intelligence of different individuals. It is a comparatively simple matter, as I have indicated, to select a proper bank. But it is not quite so easy to select a bond dealer. In the bond business it is particularly true that the trustworthiness of a firm depends on the character and experience of the *individuals* who direct the business. These qualities, of course, are not self-evident to a stranger; nor are they indicated always by fine offices and elaborate advertising. This is why the problem of selecting a bond dealer involves some difficulties.

But this matter is of the very greatest importance. From a thoroughly practical dollars-and-cents standpoint, I feel sure that the most valuable advice the reader will find in these chapters is concerned with the selection of the financial agencies — the banks and bond dealers — with which it is safest and most advantageous to do business. No matter how experienced and shrewd

one may become in financial affairs it will never pay to do business with any financial organization which is operating without sufficient capital, or in which the individuals are either inexperienced, negligent, ignorant or crooked.

Not many years ago I was a member of a firm of investment dealers in a large city. We had a very active trading department. It was the function of this department to trade over the telephone with other dealers and brokers, buying and selling all kinds of local stocks and bonds. The trader sat at his desk with a battery of telephones before him. Throughout the whole business day he constantly called or was called by other traders who wanted either to buy or sell certain stocks or bonds. It was his business to get in between the seller and the buyer. Obviously the more firms he could do business with the greater his chances of making trades. Now the local telephone directory listed in the classified section under "Investment Securities" over one hundred and fifty firms and individuals. We knew that we could not afford to trade with any but with the perfectly reliable. Out of the one hundred and fifty firms listed, twenty was the greatest number we dared have a transaction with, and of these we were always quite dubious about several. Moreover, with all our precautions, we were stung a number of times by firms who went back on trades, gave us short checks or were unable to pay for securities when delivered.

I am quite confident that most inexperienced

people would not know how to differentiate between these firms. All were listed under the heading, "Investment Securities," in the directory. Yet not more than eight or ten at the outside would pass the test I shall give for selecting an investment house. Let me say again that this is a matter of the utmost importance. If one were to divide the risk in the making of an investment into two parts, (1) the risk that one's own judgment as to the safety of the investment might be wrong, (2) the risk involved in making the investment through an unreliable agency — *the latter risk would, in my opinion, be infinitely the greater of the two.* And at the same time it could, far the more easily, be eliminated. No business experience is necessary for this and it is not at all difficult, but it does require a certain amount of painstaking effort.

The Bond Dealer

The bond dealer is a merchant; like other merchants his function is to buy at wholesale and sell at retail. The larger dealers in bonds are both wholesalers and retailers and purchase issues of securities direct from municipalities and corporations. These larger dealers are more properly called investment bankers. "It is essential to the proper performance of the services of an investment banker," writes a well known financial authority, "that he be endowed with extreme honesty and dependability, that he have a wide knowledge of general business and economic conditions,

keen foresight, sound judgment, a high degree of financial skill and the willingness to assume great responsibility." To these qualities we may add the requirement of sufficient capital.

The final selection of a bond dealer should be made on the basis of the information obtained from bankers or from the bond dealers themselves. It seems to me important to have a number of opinions, rather than just one.

The method I should pursue would be to interview four or five officials of different banks (your questions will be answered even though you are not a customer) and request that each name the two or three investment firms which, in his opinion, are the most trustworthy.

The point to bear in mind is this: the *only* opinions of any value whatever concerning the reliability of a bond dealer are the opinions of *bankers* and *bond dealers*. Do not ask your grocer, your lawyer or your doctor. The question of reliability, as I have said, has to do with the character and experience of certain individuals, and such a question can be answered only by men who know them very intimately in a business way.

Other Methods of Attack

If you wish to get the information from the investment dealers themselves, you might try the plan conceived under similar circumstances by a customer of mine when I was a youngster in the banking business. He was a manufacturer with

a new product which he wished to advertise nationally. His problem was to find the very best advertising agency for his purpose. He went to Chicago and New York, visited the leading agencies, talked over his business and put to each this question: "Next to yourselves, what agency in the country would you recommend as being the best to handle my business?" A large number named the same agency as being second best—and this agency got his business.

A shrewd question of this sort gets good results. The point is this: the most reliable information as to the character of a firm is to be obtained from others in the same line of business, but the inquiry must be framed in such a way that it will bring out *real* opinions. One of the questions which the Committee on Admissions of the New York Exchange asks the sponsors of a proposed new member is, "Would you take this man's check for $20,000 in the ordinary course of business?" The London Stock Exchange uses a similar query.

This will also illustrate the idea: if you ask a business man, "Is the firm of John Jones & Co. reliable?" he will naturally be very cautious in his reply. He will feel that it is poor business to "knock" another business man and, although he may not think very highly of Jones, it is very unlikely that he will say so directly. But, if you ask him the name of the firm which he considers "most reliable," he will have no hesitancy about giving a definite answer.

This is a matter you must take particular pains with. If you proceed conscientiously, you are certain to find that expert financial opinion places one or two firms at the top of the list. These are the ones, and no others, with whom I recommend that you do business.

What to Do Next

I think that if I had made my selection of a bond dealer in this way, I should, when I was ready to make an investment in bonds, go to the office of the chosen bond house, ask for a member of the firm and tell him how and why I decided to do my bond investment business with him.

A more flattering compliment could hardly be paid a bond dealer, or any business man, than to inform him that it had been found to be the opinion in financial circles that his firm occupied the very front rank. The bearer of such a message is certain to be very welcome. This suggestion, however, is most emphatically not intended to intimate that any special introduction or any devious method is necessary in order to get attention from the largest and best bond dealers. Such is certainly not the case. Every intelligent bond dealer wants new customers. He especially desires the business of the small bond buyer, and he will give it particular attention. Many times I have heard bond men compare notes on their scales of a new issue of bonds, and invariably I have noticed that they place more importance on

the *number* of customers sold and a *small* average sale than on large sales to wealthy buyers.

On the other hand, I do wish to suggest that you will find it very advantageous to become acquainted with one or more of the responsible heads of your bond house and to hold to the practice, when you are ready to make an investment, of going to the firm's office and transacting your business with one of the men you know.

The Right Attitude of Mind for the Investor

There is an attitude of mind indicated here which, as a general rule, will prove very protective. The investor who, when he has idle funds, takes the position that he will entertain every proposition that comes along and pick out the most attractive one will more than likely make his decision in favor of the cleverest salesman instead of the soundest investment. On the other hand, one who has the independence to do his investment business only with one, or possibly two, selected firms to whom he goes of his own accord when he is ready, not only saves himself much time and annoyance by not interviewing every financial agent or salesman who calls but, in addition, he avoids the risk of being "sold" something that he does not want.

The most important general principle I am seeking to inculcate in this chapter and elsewhere in this little book is that the investor, *every* investor, should protect himself in *all* his financial dealings by making the most careful selection of

those financial institutions with which dealings are to be had. And that these selections are to be absolutely exclusive. *Business is to be done with them and no others.* I have sought to make my directions specific and practical, so that anyone, with business experience or without it, may follow them and achieve the right result.

At the Very Least

Possibly, however, my directions involve too much trouble (the process is somewhat complicated, I admit) or, in spite of my reassurances, you may hesitate about asking so many questions. Whatever your diffidence, however, you may, at the very least, do this: ask an officer of the bank where you have your savings account to give you the name of the bond dealer whom he regards as being the most trustworthy. One such opinion is not so good as five or six; but one opinion from the officer of a bank is worth any number from men who are not intimately connected with banking or investment dealing.

The selection of the right investment banker will not only eliminate most of the risk in making bond investments but will bring some other advantages which I shall merely enumerate:

(1) Generally speaking the best houses carry a better and larger selection of investment issues than is available elsewhere. (2) Houses with the highest reputation may be expected to use the highest degree of care to keep that reputation. (3) The investor may discuss his business with

assurance that it will be kept confidential. (4) He may depend on the house to notify him when bonds which he holds are due for payment or have been called for redemption. (5) He may cash coupons there. (6) He may get experienced advice on any of his financial affairs. (7) He may have the use of investment manuals and other financial information services. (8) He may get help in working out his tax problems. (9) If, by reason of unforeseen contingency, he is required to make a quick sale or short-time loan, he will receive fair treatment and timely assistance.

The Small Investor Gets the Same Service and Pays the Same Prices

Finally, let me say again, that all that I have said applies just as much to the small investor as to the large. I do not know of a single first-class investment banker who will not give just as careful attention and take just as much time with the purchaser of a hundred-dollar bond as he would with the thousand-dollar man. Moreover, the price will be the same to both.

In the chapters to come, the importance of studying investments and of learning to apply certain simple tests will be stressed. One should come to rely on one's own judgment as well as upon that of the investment banker. "That so many mistakes in investing money are made," says Pratt, "may be said to be due either to too much dependence upon oneself or too much dependence upon others."

The investor, who has the money, must necessarily accept the responsibility of deciding which of two or more investments recommended by his investment banker he will purchase. The fundamental points on which such a decision should rest will be explained in the following chapters.

Chapter V

Buying Bonds

Why the Investor Must Rely in Part on His Own Judgment — Consulting the Banker — Free Advice

AN individual who confines his purchase of bonds to a really first-class investment banker has eliminated nearly, but not quite all, the avoidable risk in making bond investments.

The balance of the avoidable risk may only be removed by making his own judgment a really effective check upon that of the bond dealer. This requires no special talent or great ability. It is a thing which the average person can learn to do very well. It only takes a little study and understanding. In fact, it is easy; and moreover, the materials for study are available almost everywhere—in few fields are the sources of information so well organized and so easily accessible. You will recognize this as you read further. Lastly, to the average person, the study of his investment problems is most interesting.

The reason why I am not willing to advise the reader to depend entirely on the advice of his investment banker is that investment bankers make mistakes. They not only make a few mistakes which human judgment cannot possibly avoid (this character of risk is very small, but absolutely inescapable in investment) but also

they occasionally make mistakes which are avoidable. No investment banker can afford to make bad mistakes, and none ever takes up a piece of business except with the best of intentions and full confidence of success. But running a bond business presents certain peculiar difficulties.

Problems of the Bond Business

In the first place, the business has expanded tremendously and become very highly organized since the War. It is estimated that the Liberty Loan campaigns served to raise the number of bondholders in this country from 500,000 to 20,000,000. An enormous number of Liberty bond buyers became permanent investors. They learned that bonds could be purchased in small amounts, and that a wide choice was available, together with a good return, safety and marketability. And so, investment banking organizations had to be built up to serve these new buyers.

When I first entered the bond business we hardly ever sold bonds in blocks of less than \$5,000 or \$10,000. Ten years later the average sale was under \$5,000 and there were a great many \$100 and \$500 sales. This development changed the character of the business radically. It increased overhead costs tremendously, cut down the average profit per sale, made a large volume of business a requisite of success and necessitated the building up of large sales organizations.

Due to the fact that the investment-banking business has always attracted men of a high type, this difficult situation was well handled. But one or two small evils were not avoided. The most common criticism that I hear of the business is of the sales end. As Sturgis puts it, "The investment business has developed in such a way and the competition in it has become so keen that the placing of securities has become too much a matter of selling ability rather than of judgment or value." This, however, is a relatively small matter and the reader who follows all the suggestions of the last chapter will hardly believe that grounds for this criticism exist.

The Weak Point in Investment Banking

The main weakness of the business which has grown out of its expansion is the necessity which is imposed upon every investment banking firm to have on hand a sufficient variety and supply of securities to keep the sales force fully employed at all times. The source of this supply is almost entirely in new issues of securities; for the margin of profit in trading in old issues is much too narrow to make it possible to utilize salesmen to advantage. Now, the volume of new issues is something which is not governed or influenced by the requirements of the investment banking business, but rather is dependent on the demands of industry for new capital. It frequently happens that when the demands for bonds is best the sup-

ply is lightest. Then you hear the dealers say, "Business is good, but we have nothing to sell."

When such periods occur there is obviously a temptation, sometimes it seems to be almost a necessity, for the investment banker to lower his investment standards a trifle and handle securities which he would not handle if the supply of first-class issues were up to his demand. All experienced investment bankers understand this, fully as well as the writer does, and their mistakes are very few. Such errors as are made almost invariably have to do with securities of new and untried companies which will flourish if conditions are good for a long enough period, but are particularly vulnerable in the event of a sudden slump. It is with this situation in mind that I have placed such great emphasis in the next chapter on the investment requirements of earning power proved over a long period, on the elimination of all new enterprises from consideration, and on the value of comparisons. These tests are easy to apply and they will, I believe, from a thoroughly practical standpoint, be all that is necessary to make the investor's judgment a reliable check on that of his investment dealer.

On Consulting the Banker

Very frequently it is suggested that the investor consult his banker for financial advice and as a means of applying this check. There are two good reasons why this is not entirely practical as a general rule. First, a great many bankers re-

fuse to take the responsibility of advising their customers on specific investments. They are perfectly willing to help depositors find a reliable bond dealer; they are all genuinely anxious to protect customers against fraudulent and risky promotions; but they realize that every specific investment should be subjected to a certain amount of investigation and analysis, and, as every large bank now numbers its depositors in the thousands, they feel that to undertake the task of scrutinizing investments for all their customers and to do the work in a conservative manner would involve much too great a burden.

The second reason why I regard consulting your bank for financial advice as not being a practical general rule is that many large banks are now in the bond business; and I have already explained why the investor should not rely absolutely blindly on the recommendations of his investment dealer. He must develop his own judgment to a point where he can use it as a check on that of the dealer, and he must accept the responsibility of making final decisions himself. It is my opinion that the bond departments of large banks should be regarded by the investor just as he regards the investment dealers not connected with banks. Both conduct their businesses in the same way, offer the investor the same advantages, and are subject to the same criticisms.

The chief officers of a large national bank are likely to devote practically their whole time to the commercial banking end of the business. This

means the making of loans, the granting of credit, to merchants, manufacturers, farmers, cattle-men and other customers. To do this well requires keenness and very careful attention to details. And it is in this way, for the most part, that the deposits of the bank are invested. Bonds are bought, but, as a rule, merely to fill in. For the most part bonds are regarded as useful for the temporary employment of funds and government bonds constitute the bulk of such purchases, supplemented mainly by high-grade short-term issues of municipals and corporations. For this reason the average bank does not have to be an expert bond buyer, and, in so far as he is a bond buyer, his problems are entirely different from those of the individual investor. This is another reason why many bankers do not like to be consulted regarding the specific investments of their depositors.

Free Advice

It has become quite the thing in recent years for magazines (not necessarily the financial ones, but particularly the general periodicals) to establish investment departments in charge of an editor who gives free financial advice to readers. These departments have a certain value, but one must remember that they have generally been organized with a two-fold purpose, first, to serve readers; second, to attract financial advertisers. The significance, for us, of the second purpose is that the editors are likely to be very partial toward the offerings of their advertisers. Hence this sort of

free advice should usually be taken with a grain of salt. I mention this because I frequently see in the most reputable magazines advertisements of investment houses which I know lack conservatism in their business methods.

This chapter, together with what follows in succeeding chapters, is written, for the most part, from the standpoint of the investor in corporation securities—the bonds and stocks of railroads, electric-light and power companies, gas and telephone companies and industrial enterprises of all kinds. This is the most difficult field and it requires the most attention; moreover, for the average investor, it holds the best opportunities.

Chapter VI

Four Groups of Bonds

Hold On to Your Liberty Bonds — Municipal Bonds — Practical Considerations — Foreign Government Bonds — Real Estate Bonds

A BANK officer whose desk is so placed that he receives a great many inquiries from depositors, particularly regarding investments, tells me that a very large proportion of the investment problems which are put up to him come from men or women who have from $100 to $1,000 salted away in Liberty bonds. They read in the morning paper that such and such a stock is paying 8% or that "International Sixes" are selling at a ten-point discount. Without further consideration or further study they are seized with a sudden hunch that this or that is *the* great opportunity and they can hardly wait to sell their Liberty bonds to make the new venture. "When I question these people," he says, "I generally find that their Liberty bonds are actually the only securities they own which they can cash in on. Many say that they have other investments, but, on examination, these usually turn out to be real estate speculations, worthless oil or mining stocks, blue-sky promotions, or interests which they have acquired in small business enterprises of their friends or relatives. I am more and more convinced that what the average person calls his investments are not really investments at all. He

goes into these things on the spur of the moment without any more investigation or judgment than a child would bring to bear, and, after his money is in, it is absolutely irretrievable—like salt spilled in the ice-cream."

The soundest advice for such people is just what this banker gives, "Hold on to your Liberty bonds."

Hold On to Your Liberty Bonds

My observation is much the same. The man who is steadily accumulating new money should study the investment of these savings and learn to place them safely in various fields. It is for such persons that this book has been written. It is decidedly *not* my theory that you should continually be transferring your investments from one field to another (always in the direction of greater risk) as you progress in your investment experience and learning, but rather that you should invest in the safest fields first, keep these investments and put new savings into new fields. It is my advice also to hold on to your Liberty bonds. This is very important for the type of investor who is in my mind in the writing of these hints. But it is ten times as important, a thousand times as important, for men and women who are not saving new money and whose Liberty bonds are the only real investments they own. If you can find it in the Public Library, look into *Putnam's Investment Handbook* by Albert W. Atwood; on page 82 is quoted a short article entitled *Bonds*

are Bonds by Ellis Parker Butler, the author of *Pigs is Pigs*.

Broadly speaking, municipal bonds, next to U. S. government bonds, afford the safest field of investment. Many of the books mentioned in Chapter IX cover the subject thoroughly. Chamberlain, whose "Principles of Bond Investment" *is probably the best known book on investments and is to be found in every public library, is particularly good on this subject. I will mention several practical considerations for the amateur investor to keep in mind. Experience indicates that municipal bonds are thoroughly safe when (1) they are direct general obligations, (2) for widely approved purposes such as streets, sewers, public buildings, parks, water works and schools (3) of established towns and cities not dependent on a single industry (4) with populations, say, over 5,000 (5) and with total debts not over the general average for cities of the same character. Under reliable advice these requirements may be considerably modified with safety.*

Special Risks in Municipal Bonds

Bonds of all the states appear to be entirely safe at this time; though some investors and institutions will not buy state bonds because the law does not permit an individual to sue a state. What little risk there is in state bonds and municipal bonds is largely, it seems to me, that funds raised by bond issues might be used for an unwise purpose. History indicates that defaults have

most generally been due to the failure of over-ambitious schemes which proved to be economic or engineering blunders. When such enterprises do not pay, the risk of default becomes appreciable. Thus it is, and should be, recognized that there are special risks attached to bond issues for irrigation, drainage, railroad aid, harbor development, electric-power plants, tramways and the development or acquisition of propositions which are ordinarily left to individual initiative.

Many financial authorities insist that bond issues should be paid off serially within the expected life of the properties for which they are issued. Highway bonds, for example, should mature in installments before the highways have to be rebuilt. This is undoubtedly sound.

School district bonds, in my opinion, may be safely bought, on the advice of a competent bond man, where the population runs even as low as 1,000, provided the total debt is reasonable and the district is in a well settled and established section. Special assessment bonds of paving, sewer districts, and the like, should be purchased only by experts or specialists who understand the particular risks involved and know the local laws governing such issues.

Legality Absolutely Essential

Legality is of absolutely fundamental importance in municipal issues. This is a matter which may be left to your investment banker who, for every issue he buys, obtains the approving opinion

of a firm of attorneys who specialize in municipal bond law. A copy of this opinion may always be had for the asking and it is good practice for the investor to file it, together with a copy of the bond dealer's circular, with the bonds of each issue which he buys. This will save much trouble in the event it ever becomes desirable to sell the bonds to a dealer who did not originally handle them.

Municipal bonds (this term is used in a broad sense to include bonds of states, cities, school districts and other local government units) are exempt from federal income taxes. As a general rule, also the bonds of a state and its local units are exempt from the state and local taxes of that state. There are a few exceptions to this, in Ohio for example. Non-taxability is a desirable quality. Indeed, as long as we have graduated income taxes, it is likely to be an essential requirement for the investments of persons with very large incomes. This desirable quality raises the price level of municipals as compared with taxable bonds. It is most valuable, however, for persons of the largest incomes and only of slight, often of no value, for investors of small incomes. A person whose income is small enough to make him exempt from the income tax obviously need not concern himself about tax-exempt bonds; but one whose income is so large that he is taxed at the rate of 30%, for instance, is forced to consider the matter very seriously—for him a 6% taxable bond will yield net, after paying the income tax,

only 4.20%; hence any good, tax-exempt municipal bond yielding over 4.20% will be a better investment for him than an equally safe 6% taxable bond. Whether to buy tax-exempt bonds or not is something which each individual must work out for himself, and, as indicated, the decision should rest mainly on the rate of his income tax. Reliable help in this matter may be obtained from the investment banker who is necessarily well informed on the subject.

Foreign Bonds

It is difficult to formulate any general rules which will be very helpful for the investor in the consideration of foreign bonds. For the most part foreign financing is a new field for American investment bankers and investors and, moreover, the major portion of such financing in our market has grown out of or been intimately influenced by an unprecedented set of circumstances — the World War and its aftermath. The observation has been made that only a few of our bankers have much background or experience to fit them to enter the foreign fields safely. On this account some bond dealers make it a rule to stay out of foreign bond syndicates unless well known London houses are in the business also, the idea being that the far greater experience of English financiers in foreign government financing is something to be depended on as a check to American judgment.

Credit Standards for Foreign Issues

The following points should have weight: (1) credit record of the country; (2) moral and business character of the population; (3) political stability; (4) monetary system; (5) purpose of loan. Obviously a country which has defaulted may do so again; if the individuals making up the population are not scrupulous in personal and business transactions, the government will probably be slack; the risk of revolution, as witness Mexico and Russia, is most important; if the monetary system is on a gold basis, the credit risk is far less than with a paper-money system. The effects of the latter are very far-reaching, not only on ability to make gold payments on debts contracted in gold but on political stability and the moral risk as well. As to the purpose for which the loan is made, the risk is of the same nature as that connected with our domestic state and municipal issues. It is well to apply the same standards strictly. Many foreign loans have been made for purposes which we should not countenance for a moment with domestic issues.

Very little emphasis is to be put, I think, on the points most generally stressed in bond circulars—per capita debt, value of government-owned property, and extent of natural resources. It is well for the investor to give foreign issues careful consideration; for the volume of such financing will probably continue large, and the terms attractive.

Real estate bonds have come to occupy a very important place in the investment arena. There is a tendency to put them in a category separate from other corporation bonds, and to apply certain special standards of judgment. The tests which I have laid down in the following chapters have been so designed as to be strictly applicable to real estate issues, as well as to all other corporation securities, and should always be conscientiously adhered to.

Chapter VII

The Fundamental Investment Test

Sound Finance Has Not Displaced Unsound Finance—Earning Power, the Fundamental Investment Test—Must Be Proved by Actual Results — How Much Earnings? — New Enterprises Are Never Investments — Friends and Relatives — New Issues

THE points made in this chapter are based on the assumption that the directions regarding the choice of a bond dealer have been successfully followed. If this has been done, the greater part of the risk in making investments has been eliminated and the investor may safely disregard most of the technical factors which determine the value of a security. It is necessary and wise, however, for the individual to understand and use as tests one or two fundamental standards which are broadly applicable to the whole field of corporation bonds and stocks, and these will be found herein.

Unless one is familiar with financial history in detail it is hard to realize how tremendously important and advantageous the modern development in finance is for those who are saving money. It may truly be said that sound banks and safe investments available for everybody are blessings known only to recent times. In the seventeenth century in England, as Walter Bagehot points out, if a man did well, the safest investment he

could make was to hoard gold coin. The father of Pope, the poet, did this, taking a chest containing £20,000 in coin when he retired from the city and went to live in the country. This situation was largely responsible for several periods of exceedingly wild speculation in blue-sky promotions such as the South Sea Bubble. The people were the more easily taken in there because there were practically no facilities whatever for investing money legitimately.

In this country the development of a sound banking system has occurred within the recollection of men still in active business and the establishment in 1913-14 of the Federal Reserve System, which made our banking structure the strongest and best the world has ever seen, will be remembered by all who read these words. The widespread distribution of the securities of established and conservatively managed corporations as investments is also a very recent development.

This fact, however, is of the utmost importance —*sound finance has not displaced unsound finance.* The latter exists in all the old forms and is constantly augmented by new inventions; it takes the names and dons the habiliments of every phase of sound finance. Every device possible to human ingenuity is utilized to make the counterfeit look real. Hence the necessity for taking those precautions against having dealings with any but sound institutions as herein recommended. Hence the necessity also for rules or tests which will make it possible to discriminate between the

sound and the unsound. These tests must be fundamental so as to apply to all kinds of investments. They must be easy to understand and to use so that the inexperienced as well as the experienced may find them valuable.

The Fundamental Criterion

The fundamental, all-important consideration in the appraisal of an investment is EARNING POWER—*the earning power of the property on which the investment is based. This is a matter which can hardly be emphasized too strongly.*

One of the most valuable single concepts which the student may obtain from the study of economic principles is that value is derived from income, not income from value. As Professor Fisher says in *The Elementary Principles of Economics,* "The value of capital *must* be computed from the value of its expected future income. Not until we know how much income an item of capital will bring us can we set any valuation on that capital at all. It is true that the wheat crop depends on the land which yields it. But the value of the crop does not depend on the value of the land; on the contrary, the value of the land depends on the value of the crop."

This defines the method of approach to the problem which the investor must always employ in estimating the worth of any kind of property whatever as security for an investment. Not original cost, re-production cost, book value, or

appraised valuation, but *earning power* is the criterion.

Earning power, therefore, is a factor which you must examine very closely. The safety of an investment is determined by the certainty of interest and principal payments, and these must be paid from earnings. Hence *earning power determines the safety of an investment.* Now there is positively no method of judging earning power except by the record. Every house, every apartment, every office building, farm, railroad, factory and power plant differs in some respect affecting earning power from every other. This difference may be in management, location, methods, efficiency, supplies of raw material, or in a thousand other ways, all bearing on earning power. It follows, therefore, that you may not rely at all on any statement of earning power which is not based on the *actual results* obtained by the property under consideration. No estimate of earnings based on the performance of other properties or on the expectations of engineers, accountants, promoters or other human beings is worth very much.

How Much Earnings?

How much earnings are necessary to make a property a safe basis for investment? The answer to this is plain: the earnings must be such as to demonstrate to a careful inquirer that there is no danger that obligations of every kind will not be met even in the leanest periods likely to be

encountered. For a company whose business is fairly steady from year to year, such as a railroad or public utility, *the common standard is that earnings available for interest shall be at least twice all interest charges.* "Earnings available for interest" may be defined as that amount remaining, after providing for all expenses, taxes, repair costs and depreciation charges. If the net amount remaining is twice the amount required to pay the interest on bonds, notes and other debts, it is usually deemed sufficient; provided always that experience indicates that there is no likelihood that earnings in any year will ever fall so low as to make the payment of any obligation embarrassing. In lines of business where fluctuations of earning power are considerable, as is the case with most industrial and merchandising concerns, the requirement for earnings in relation to interest charges must be raised accordingly. Finally the record of earnings must be examined over a period long enough to include some years of business depression; and it is good practice to discount recent earnings somewhat and give more weight to those several years back.

This record, for all companies of importance, will be found in one of the investment manuals described in the ninth chapter. The great value of these books lies in the fact that they contain compilations of earnings and other statistics of all large corporations extending over a long period and so conveniently arranged that the gist of the figures may be quickly apprehended.

Earning power, then, is the fundamental investment test. If the investor understands this completely and applies it conscientiously, if he looks up the record himself and if he makes his investments through the right kind of investment banker, he may feel, with the greatest confidence, that he has taken all the really essential precautions. I do not mean that meeting these simple requirements will qualify anyone as an investment expert; there are other considerations, of course, and I shall presently indicate how they may be followed up. Knowledge in financial matters, as elsewhere cannot be too great. What I do mean is this: if you follow these directions in investing your savings, it is almost certain that you will *not* lose your money; if you do not follow them, at least substantially, it is fairly certain that you *will* lose it.

Ring Out the New, Ring in the Old

As a corollary to what has been said, it follows that *new enterprises are never investments.* Adam Smith, the father of modern economics, wrote, "The establishment of any new manufacture or any new branch of commerce or any new practice in agriculture is always a speculation." This is as true today as it was when written, and "speculation" is the exact word to apply to new ventures of whatever kind. It is said that 80% of new enterprises fail in the United States year in and year out. I have taken particular pains in this book to show the reader how to avoid the toils

of the fraudulent promoter, and this danger has, perhaps, been overemphasized. John Moody says that, in his opinion, more money is lost by people who think they are investing when they are really speculating than is lost by fraud—and the figure for annual fraud losses is set at over half a billion dollars by the Federal Trade Commission. As a matter of fact, only a small part of the failures which occur are due to fraud. They are mainly due to lack of capital, inexperience, carelessness and general incompetence. Most of the failures, also, are of small businesses. Such businesses, as a rule, are financed by the active parties, or by them and their friends and relatives. And here we have one of the most fruitful sources of loss for the average man of fair or small means — the loss due to investing with friends and relatives.

Friends and Relatives as Financial Advisers

To avoid friends and relatives in making investments may seem to be harsh advice. What is more natural than for the widow with her insurance money, the inexperienced person of every kind, to turn to close friends and relatives for help in making investments? If Cousin Charlie is putting his own money into his new patent cherry-picker or is opening a new haberdashery store, it is obvious that he believes he has a good thing and is perfectly sincere and well-intentioned when he advises poor Tom's widow to put her money in also. And likewise Uncle Bill, who is

selling stock in the Acme Department Stores, Inc., is actuated only by benevolent and honorable motives when he takes a little of her money. And the same is true of Nephew John who has just become a bond salesman.

Uncle Bill's case needs a little elaboration; for he represents one of the promoter's best tricks and illustrates how it is possible for a worthless blue-sky stock to be sold innocently by an honorable salesman. A shrewd promoter makes a particular effort to hire, as salesmen and saleswomen, ignorant and inexperienced persons whom he can hypnotize into believing that his proposition is really meritorious. These dupes may have very little selling ability and are not expected to do well with strangers. They are set to catch their friends and relatives who may be hooked because of the salesmen's known sincerity and good faith.

A word to the wise is sufficient—keep your financial affairs to yourself. Friendship or kinship between the investor and the proprietors of a business or between the investor and a stock or bond salesman is no test of investment worth. Make no investments with friends or relatives except through the channels and under the requirements set for other investments.

Do It Yourself

This chapter has made it clear that all new promotions, together with the enterprises of friends and relatives are absolutely to be elim-

inated from consideration as investments; and it has explained the fundamental test, earning power. The test of earning power is simple and direct. It goes to the heart of the matter. This test is one which, I insist, you must learn to apply for yourself. In addition to the necessity for developing independence of judgment and self-reliance, there is a sound psychological reason for my insistence that you make this test yourself. The habit of exercising independent judgment may be formed only by repeated practice. The necessity of making a definite investigation before coming to a decision in itself is a safeguard against hasty, thoughtless, and careless action. Therefore I say, make it a rule always to look up the record of earnings yourself. Go through the motions even if you do not see the necessity or understand the process thoroughly.

New Issues

What has been said does not exclude from consideration new issues of securities—only the new issues of new companies, not the new issues of old ones. For the most part, the bonds which your investment banker will offer you will be new issues, and there is some advantage in this.

The theory on which the managers of an underwriting syndicate fix the price at which a new issue is to be sold is that the price shall be such, as compared with other similar issues in the market, that the new issue will sell readily. In other words, it must be slightly more attractive

than the old issues. If the price is set too high, the issue will move slowly and probably decline in price to its proper level when the underwriting syndicate is terminated and the price of the issue is determined in a free market. If the price is set too low, there will probably result an over-subscription and a quick advance in price. This indicates that the syndicate might have been successful at a higher figure and larger profit. The underwriting houses are very experienced judges of the bond market; hence they are generally right. As the price of a new issue must be set at an attractive figure to insure a successful syndicate operation, it is wise for the investor to pay particular attention to the offerings of new issues.

Practical Rules of a Keen Bond Buyer

The restriction to issues of old companies, of course, eliminates all issues of companies which do not appear in the investment manuals. One of the keenest bond buyers I ever had for a customer as a young bond salesman was the president of a country bank; this was when I was on the road. The town was practically a one-industry town and most of the depositors of the bank worked in this industry—it was coal mining. There was little local demand for credit; hence this bank, by force of circumstances, was a large bond buyer, and the president was an expert on bonds where most bank presidents are credit experts. It was his rule never to consider an offering unless he had the information at hand as a basis for his own

investigation. His tools were Moody's *Analyses of Investments, The Commercial & Financial Chronicle* and *The Wall Street Journal.* He would listen to my story, read my circulars and then, without a word, turn to the manual. If the corporation whose securities I was offering did not appear in the manual, there was absolutely nothing doing, and that was all there was to it. I used to be much put out when I was turned down for this reason, but afterwards, the experience of many years taught me that this banker followed one of the wisest rules an investor could make.

Chapter VIII

The Best Method of Analysis

Operation of the Investment Market—Distribution—The Market Judgment—The Method of Analysis by Comparisons — Turns Up the Weak Points

THE best way to analyze a security in a detailed way is to employ a method discoverable in the normal operation of the investment market. The wide distribution of an issue of bonds is of considerable advantage to an investor who holds bonds of that issue. Wide distribution means that the issue has been sold through bond dealers in all the large cities of the country so that there are holders everywhere. Such distribution can be attained only with large issues; I should say the minimum size is three or four million dollars. Statistics were recently published on the distribution of one of the largest of the foreign bond issues. The amount was $150,000,000; the average investment $3,660; and the total number of purchasers was approximately 44,000. About 90% of the number of sales were to investors who purchased less than $5,000 each. These figures were given out by a partner in the leading American international banking firm. He used them to illustrate a point which he apparently regarded as being of major economic importance—the great part of which the small investor has come to play in finance.

You will readily appreciate that the sale of such a large issue of bonds to so many relatively small holders scattered all over the country tends to stabilize the aftermarket for the issue and to broaden it. The tendency to stability is due to the fact that no large portion of the issue is likely to be forced to sale at any one time, and the large number of scattered holders, who are familiar with the issue and regard it favorably, create for it a continuing demand which tends to increase with any recession in price. Thus wide distribution makes for marketability.

"The Bloodless Verdict of the Market Place"

But it carries another advantage which to my mind is very important; and that is, that it results in a composite judgment of the issue's value made up of the combined estimates of thousands of investors who have studied the issue, compared it with other issues in the market, and, each acting on his own judgment, has given expression to his opinion by either buying or selling bonds of the issue; and the result of all these interactions is the composite judgment which is expressed by the market price. Great fluidity is thus a characteristic of that part of the investment market which is composed of widely distributed issues. There is a constant tendency for every investment to find its proper price level, every possible influence is felt, every purchase and every sale, for whatever reason, have their effect. The result is that the purchaser in this market has the assur-

ance when he pays the market price for a bond that this price represents not only his judgment of the bond's worth but the judgment also of many others.

You will observe that the general method by which the market judgment of value is arrived at is by the comparison of one issue with another or with many others. And this method is the one which I recommend for the detailed analysis of any security. The general procedure should be to make a detailed comparison of the particular issue under consideration with, say, half a dozen similar issues of similar corporations. Your source of material will be one or more of the investment manuals described in the next chapter. From your general knowledge, or by digging through the manuals, you will first select a number of corporations as nearly as possible like the one under consideration in point of size, character of business, territory served, etc. This is not very difficult in the case of railroads and public utilities as these are grouped together in the manuals. With industrial companies it sometimes takes a good bit of work to bring together a number of companies in the same line of business as the indexes of the manuals are arranged by corporate names only, and not by lines of business.

The Virtue of Comparisons

First of all, compare similar issues of these companies—that is, issues similar in legal status, notes with notes, first mortgage bonds with first

mortgage bonds, etc.—as to market price, yield and rating. In making this comparison you should expect to find similar issues selling on approximately the same basis. If you find one which is priced at an appreciably lower level than its similars, do not jump to the conclusion that it is therefore the best purchase. Remember that the market judgment is likely to be right. There is always a reason for difference in market prices. Issues which are "selling out of line" probably should. In making an investment analysis there is always a risk that all the facts are not available. Something may have happened since the last published figures or something may have been concealed. It is the conservative practice, therefore, to select for investment no issues which are selling appreciably below (that is, to yield more) than the average of their kind.

The great value of this general method of comparisons is that it turns up the weak points. The next step is to compare earnings along the lines already indicated, and from here the investigation may be carried on to a consideration of all the records and ratios applicable to any particular line of business. This process is encouraged and simplified by the investment manuals which are so arranged as to display similar facts for similar enterprises. There is a very excellent book on the subject also, a book for advanced students rather than beginners — Bliss's *Financial and Operating Ratios in Management.*

This work makes it clear that for different lines

of business different standards must be applied. For example: in proportion to the gross business done, an electric-power company requires much less working capital than a department store. In fact, no hard-and-fast rules can be laid down for business ratios which are applicable to all kinds of business. The only safe basis for judgment is to ascertain the practice of the most successful firms in each particular field.

Chapter IX

How and What to Study

Necessity for Study—The Investment Manuals —Moody's Ratings—Books and Periodicals—Bibliography

"THE serious practice of investment is a study and business-like pursuit," says Gaines in *The Art of Investment;* and he adds that it consists in learning facts which are within the common reach and in applying principles capable of being understood by anyone. It is undoubtedly true that financial information is more thoroughly organized and more readily available than in any other field. To make use of this information it is, first of all, necessary to know where to look for it, and, secondly, to learn the meanings of the terms and phrases ordinarily employed in financial literature. The names of stocks and bonds afford very little basis for judgment as to investment values, yet it is necessary to know what the names mean. It is wise to know a little of financial history, of the various classifications of securities, of the way to analyze a balance sheet, of the use of bond tables, of the meaning of investment ratings. These things have all been written about in simple language which anyone can understand and the important books are to be found in every Public Library.

The most important tools of the investor, as I have elsewhere indicated, are the investment

manuals. The chief ones are, Moody's *Analyses of Investments*, Poor's *Manuals*, and the card system of the Standard Statistics Co. One or more of these is to be found not only in the Public Library but also in the office of every investment banker and stock broker, where they are always available for the use of customers. A brief description of Moody's *Analyses of Investments* will make clear what the investor may expect to find in the manuals.

This work is issued annually in four large volumes, *Railroads, Public Utilities, Industrials,* and *Governments and Municipals.* In the first three volumes all important corporations in the United States are described and classified, as indicated by the volume titles. A very complete financial picture of each corporation is given, including history; character of business; officers and directors; capitalization, in tabular form describing each issue of stocks and bonds; annual income accounts, showing earning power; and annual balance sheets; with further analyses of important figures in tables. The whole is so arranged that the essential facts may be quickly arrived at. In addition, the investment standing of each issue of stocks and bonds is indicated by a *rating system.* This very great aid to the investor is the invention of John Moody and is one of the most valuable features of the *Analyses of Investments.* Similar systems are now also used by the Standard Statistics Co., Poor's and some other investment services.

Moody's Ratings

Moody's Ratings are explained in detail in the opening pages of each volume of the manuals. The following description of the three highest ratings makes the idea clear:

Aaa — This rating signifies that the security so rated is of the very highest grade. It is strongly protected by tangible assets; and earning power, under any conditions that may reasonably be expected, should be ample to cover interest or dividend requirements. The type of securities usually rated *Aaa* are Government bonds; the obligations of states and cities whose records are of the best; underlying railroad bonds of prosperous systems, and first mortgage bonds on the properties of well-established industrial and public utility enterprises whose assets are large and whose earnings for a number of years have been several times the interest requirements. There are also certain stocks in the *Aaa* class, mainly seasoned preferred issues which are not preceded by heavy charges having prior claim on the company's assets and earnings.

Aa — Bond and stock issues carrying this rating are of high grade, well protected in every way, but not so ideally situated as those which have the first rating. Sometimes the difference may be that the security is not so well "seasoned" as the issue in the *Aaa* class or it may be that there is a slight inferiority as to general investment character; or again, possibly the market for the *Aa* security is not so broad as that for the issue carrying the next higher rating. It is generally safe to consider any *Aa* security as being of very strong investment character and suitable for permanent holding by a financial institution or investor dependent upon the income from securities.

A — While implying a high degree of investment merit, securities carrying this rating are apt to be affected to some extent by fluctuations in earning power. However, such issues are to be regarded as sound, with a permanent

and substantial future, but the rating implies that the price of the bond will be apt to respond to changes in the "margin of safety" much more directly than would securities carrying the higher ratings. Furthermore, an *A* security is not always fully "seasoned" and is often an issue which has risen from a lower investment plane and has added to its strength because of improvement in earnings or general character and ability of the company's management.

The additional ratings, *Baa, Ba, B, Caa, Ca, C, Daa, Da, D, E* and *F* run on down from the slightly speculative to the worthless. "It must not be forgotten," this is quoted from Moody, "that arbitrary judgment is used to a large degree in making all these ratings. The percentages showing the factors of safety, and so forth, serve as a general guide, but the rating given is, in many cases, affected by other considerations not shown in the figures. The ratings are, therefore, to be looked upon as indicators of values, rather than as definite or final opinions."

The Basis of Intelligent Action

It is absolutely necessary for an investor who desires to handle his affairs intelligently in accordance with the suggestions made in this book to learn to use the investment manuals and the ratings with great familiarity. This is the first and most important step in our plan of investment study and is a matter which is positively not to be neglected.

The list of books at the end of this chapter contains the more important and interesting books

for the average investor. Most of these will be found in any Public Library. I have not included any that are not worth reading, but it is by no means necessary for anyone to read them all. When puzzled by any particular point it is well to read what a number of authors have to say on the subject, reading only the pertinent part of each book.

Most bond salesmen cut their teeth on Chamberlain's *Principles of Bond Investment.* The author is an investment banker of wide and long experience and his work well deserves its popularity. It is not a small book, however (neither are those of Lagerquist, Sakolski, and Kirshman, which are equally comprehensive), and if it is too forbidding for the beginner it might be well to try one of the shorter books. The list shows the number of pages in each book cited.

Of the periodicals, *The Commercial & Financial Chronicle* is the one most favored by bond men, bankers, and other professionals in finance. It is a strictly utilitarian publication and is devoted to solid matter of first-rate importance, complete quotations, statistics, prices, etc., together with classified investment items. A number of supplements to the *Chronicle* are issued at regular intervals and these are, in fact, condensed investment manuals on railroads, industrials, public utilities, and municipals. Bound and indexed volumes of the *Chronicle* afford a most valuable source of reference material for the student of finance.

For the average investor I have no hesitancy in recommending Barron's, the *National Financial Weekly*, as the most valuable in the field. It does not contain so much statistical information as the *Chronicle*, but gives the reader far more in the way of *sound financial instruction* than any other periodical. Moreover, the editorials are among the best being written in America today.

Other magazines of the popular type are *The Analist, The Financial World, Forbes' Magazine*, and the *Magazine of Wall Street;* of dailies, *The Wall Street Journal* and the *Boston News Bureau* head the list, and many newspapers have comprehensive and interesting financial departments.

Investment Bibliography

Atwood, Albert W., *Putnam's Investment Handbook*. New York. G. P. Putnam's Sons. 1919. 375 pp. A very informative book for the general reader by a well-known financial writer. Read his quotation from Ellis Parker Butler, author of *Pigs is Pigs,* entitled *Bonds are Bonds,* on page 82.

Blake, Clinton H., Jr., *Acquiring a Home*. New York, Doubleday, Page & Co. 1925. 280 pp. Covers the legal phases of the subject.

Bliss, J. H., *Financial and Operating Ratios in Management*. New York. The Ronald Press Co. 1923. 396 pp. This book is described at the end of Chapter VIII.

Carret, Philip L., *Buying a Bond*. New York. Barron's. 1924. 157 pp. Written with the average investor in mind. Interesting, instructive, and free from technicalities.

Chamberlain, Lawrence, *The Principles of Bond Investment*. New York, Henry Holt & Co. 1911. 551 pp. This is the bond-salesman's bible. Particularly good on municipal and railroad bonds.

FISHER, IRVING, *Elementary Principles of Economics.* New York. The Macmillan Co. 1913. 531 pp. A standard work. The author is professor of Political Economy at Yale University.

GAINES, MORRELL W., *The Art of Investment.* New York. The Ronald Press Co. 1922. 231 pp. A very interesting little book by an author with experience in the investment-banking business.

HERSHEL, ARTHUR HOBART, *The Selection and Care of Sound Investments.* New York. The H. W. Wilson Co. 1925. 373 pp. Contains a number of practical ideas on both stocks and bonds as investments. Treats "legal" investments rather fully.

JONES, EDWARD D., *Investments.* New York. Alexander Hamilton Institute. 1922. 317 pp. The author was formerly Professor of Commerce and Industry, University of Michigan. This is one of the Alexander Hamilton Institute text-books and may be bought separately from the complete course. A good treatment of the subject.

JORDAN, D. F., *Jordan on Investments.* New York. Prentice-Hall. 1920. 423 pp. The author is Assistant Professor of Finance at New York University. Covers briefly the broad field of finance and investment.

HAMILTON, WILLIAM PETER, *The Stock Market Barometer.* New York. Harper & Brothers. 1922. 347 pp. An instructive study of the forecast value of stock market movements.

KIRSHMAN, JOHN EMMETT, *Principles of Investment.* Chicago. A. W. Shaw Co. 1924. 902 pp. A comprehensive work on all phases of investment by the Professor of Finance at the University of Nebraska. Contains a dictionary of financial terms.

LAGERQUIST, WALTER EDWARD, *Investment Analysis.* New York. The Macmillan Co. 1922. 792 pp. This is a standard work. Contains probably the best bibliography on investments ever compiled, and is very valuable as a work of reference and as a text-book for students.

MEAD, EDWARD SHERWOOD, *The Careful Investor.* Philadelphia. J. B. Lippincott Co. 1914. 290 pp. Written from a sound and conservative point of view by the Professor of Finance at the University of Pennsylvania.

MEEKER, J. EDWARD, *The Work of the Stock Exchange.* New York. The Ronald Press Co. 1922. 633 pp. One of the best books about the Stock Exchange.

PRATT, SERENO S., *The Work of Wall Street.* New York. D. Appleton & Co. 1908. 186 pp. By a former Editor of The Wall Street Journal and former Secretary of the New York Chamber of Commerce.

RAYMOND, WILLIAM L., *National Government Loans.* New York. Barron's. 1925. 275 pp. Treats of foreign bonds. Contains a brief financial history of the United States and of the more important foreign governments which have borrowed in the American market.

SAKOLSKI, A. M., *Principles of Investment.* New York. The Ronald Press Co. 1925. 503 pp. The author has been a lecturer on investments at New York University for a number of years and is connected with a prominent banking house. This work is comprehensive and very valuable.

SMITH, EDGAR LAWRENCE, *Common Stocks as Long Term Investments.* New York. The Macmillan Co. 1925. 127 pp. A very interesting little book on the effect of the fluctuation in the purchasing power of the dollar on investments in bonds and common stocks. Also treats of the tendency of common stocks to increase in value through the reinvestment of undistributed earnings.

STURGIS, HENRY S., *Investment a New Profession.* New York. The Macmillan Co. 1924. 210 pp. Proposes a rather idealistic plan for reform of the investment banking business, but contains many suggestions interesting and valuable for the bond dealer and the investor alike.

VAN RIPER, WALKER, AND OTHERS, *Investing for a Widow.* New York. Barron's. 1926. 167 pp. The prize-winning and next best articles submitted in a prize contest conducted by Barron's in 1925 for the best plan for the investment of $100,000 for a widow with two young children. A specific investment problem attacked by experts.

Van Strum, Kenneth S., *Investing in Purchasing Power.* New York. Barron's. 1925. 248 pp. A highly informing study of the investment problem created by fluctuations in the purchasing power of money.

Correspondence Courses

Alexander Hamilton Institute, *Joseph French Johnson, Editor-in-Chief.* An excellent correspondence course in modern business and very valuable for the investor.

American Chamber of Economics, *George E. Roberts, Editor and Supervising Director.* This is a valuable course in economics for executives by a Vice-President of the National City Bank.

CHAPTER X

Earmarks of the Fraudulent Promotion

Anyone May Recognize Fraudulent Promotions at a Glance—The Bond Dealer's Circular—Characteristics of Promotion Literature—How Earning Power Is Treated—Trustee, Transfer Agent and Registrar—Confidential Information—Testimony of Amateurs

IT does not take a great amount of worldly experience to recognize a member of the oldest profession. To the person with any financial training, the outward and visible signs of the fraudulent promotion are even more manifest. But, considering the number of victims who are unable to read the character of the fake financial scheme, this matter must have our attention. The annual losses in the United States from this sort of thing are variously estimated from a quarter of a billion to a billion dollars. Some years are, of course, much worse than others. At times the whole country goes mad with a speculative fever, and these are the promoter's fat years.

Years ago I started the practice of keeping a file of financial-advertising literature of all kinds. I got my name on all the sucker lists and, as well, on the lists of prominent bond houses and banks. I accumulated a great mass of printed matter, all of which was carefully preserved and indexed. When any of my correspondents failed or got into trouble, I made notes to that effect on the

file folder or pasted on it the newspaper clippings. After ten years or so I had collected quite a rogue's gallery of those who had failed, absconded, or landed in a Federal prison for using the mails to defraud. Some of this "literature" was pretty crude, but most of it was diabolically clever. I found, however, that it was not very difficult for me to separate the sheep from the goats. There were certain lines of argument and methods of presentation which were almost invariably employed by the fakers and *never* by the legitimate investment dealers. A brief classification and explanation of these methods of fraudulent finance will make it possible for anyone to recognize the blue-sky promotions at a glance.

The Bond Dealer's Circular

In the first place, you have probably noticed that circulars issued by bond dealers are very much alike, both in subject matter and arrangement. The ordinary corporation bond circular contains four pages—on the first page, at the top, are the amount and title of the issue; next in finer print a section giving the dates of issue and maturity, interest dates and places of payment, redemption prices and sinking-fund provisions; then in slightly larger type, the name of the trustee. Below this there follows a summary of the information found in the following pages; then a paragraph giving the names of the accountants, appraisers and attorneys; then the price and yield; then the name of the firm offering the issue. Pages

two, three, and four generally contain a letter from the president of the corporation addressed to the underwriting syndicate and giving in detailed and orderly fashion a short history of the company, the statistics of its business, the purpose of the issue, etc. These are the representations on which the issue has been purchased by the underwriters and on which the offering is made to investors. Hence the phrase which appears in substantially this form on every bond circular, "The information contained in this circular is obtained from sources believed to be accurate but is not guaranteed." Such a circular is apt to be conservative, uninteresting, even forbidding in appearance. It is usually printed on medium-grade paper, in ink of one color; that is to say, it is done economically and practically.

I have described the legitimate circular in detail in order to illustrate very forcibly the first point —the advertising matter or "literature" of the fraudulent promotion is *invariably* attractive in appearance, interesting to read, and expensively printed. Whenever you begin to receive a series of letters, booklets and pictures as interesting and flashy, and colorful as a circus parade, be on your guard. The real thing is not done that way.

William Blake once made the observation that there are two opposing forces in the universe, "the principle of vitality, commonly called evil, and the principle of repression, commonly called good." Taken literally, this dictum is very pat to the distinction just made between fraudulent and legiti-

mate advertising literature. That distinguished by the principle of vitality—lively, colorful, eloquent—is almost certainly to be called evil; and that composed according to the principle of repression — conservative, restrained, even forbidding, is probably good.

The Promoter's Meat Is the Little Fellow

In the next place, blue-sky promotion literature is *invariably addressed to men and women of small means,* the theory being (and this is, of course, sound) that such people are inexperienced, hence are easy marks. The promoter expects to make a $1,000 sale only rarely, but on each $100 sale he makes a profit many times what the legitimate bond dealer makes on a $1,000 bond. The appeal to the small investor always contains much *altruism and brotherly love*—"for the first time in the annals of American finance the *little fellow* is given a glorious opportunity of getting in on the ground floor of a great industry. This defiance of the evil tradition of Wall Street has set the greedy plutocrats and the powerful banking interests against us, but with your help and the help of thousands of citizens of moderate means like you we will etc., etc."

Often it is represented that the *"Wall Street interests have tried to buy all the stock,"* but the magnanimous promoter will not permit it — the little fellow must have his opportunity. There is generally some mention made of the low rate of interest paid on savings accounts, together with

the statement that the banks pay out only a meagre rate of interest, but with your deposits they buy control of the great industries and take in fabulous profits. But remember this: banks are prohibited by law from buying stocks; and you may easily find out the rate of income received by the banks on the investment of deposits by consulting the annual report of the comptroller of the currency. For large national banks it averages under 6% (this is the gross amount, before deducting expenses, interest paid on deposits, etc.).

Advertising that *on a fixed date the price is to be advanced* is something I have never known to be done in a legitimate deal. It is merely one of the methods of rushing the suckers off their feet. *Door-to-door canvassing,* as a general rule, is too expensive for any but blue-sky stocks.

Proof by Analogy

The promoter, of course, never gets down to brass tacks in his printed matter; glittering promises are there in plenty, but few facts. *Earning power,* that fundamental, all-important consideration, is *never* established by experience or definite figures, but is estimated on the performance of Standard Oil, General Electric and other great companies. Profits are indicated by showing how a small sum originally invested in Ford, Gillette, or Bell Telephone became a fortune. And, of course, a balance sheet is rarely to be seen in promotion advertising. There is a very good reason for indefiniteness, the use of innuendo, and anal-

ogy—definite promises and representations which are untrue are tickets to a federal prison.

You will frequently see a prominent bank named as Trustee, Transfer Agent or Registrar in circulars describing shady or risky issues of stocks and bonds. I have often heard such banks criticized. Sometimes there is a basis for criticism and sometimes not. A bank offers its services as Trustee, Transfer Agent, etc., to the public at large, just as it offers to take bank deposits. The bank officials must necessarily assume that the individuals who seek the bank's services are honest and are acting in good faith. No intelligent banker will ever accept business, of any kind, from a person he knows to be crooked. But it is not practical to investigate the character of every new depositor, nor is it possible to go into the merits of every proposition for which the bank is asked to act as Trustee.

It is necessary for the investor to understand that Trustee, Transfer Agent or Registrar, whoever they may be, have absolutely no bearing on the MERITS *of an investment. They have nothing to do with the management of the business and no relation to its success or failure. The Transfer Agent is merely a third party, supposedly neutral to the stockholders and the company, who transfers stock certificates; and the Registrar registers them as a guard against possible over-issue. The main duties of the Trustee who acts in connection with an issue of bonds have to do with foreclosure in case of default. It follows, therefore, that*

whenever the name of the Trustee or Transfer Agent is displayed in large type as if to imply that the bank acting in that capacity is a party to the promotion and endorses the statements in the circular, the reader should beware. The thing is done for one reason only — to deceive. It is NEVER *done in a legitimate offering.*

Almost Invariably a Sign of Danger

The representation that *certain banks or certain prominent men of wealth have invested in the issue* should always be a warning to the investor. I have never known a bank to authorize a bond dealer to use its name in this way. The business of a customer should be and is a matter of the strictest confidence with legitimate dealers in securities. One of the most wicked promotions in recent years was a large chain department-store scheme. After the thing blew up, I learned that a great many of the employees of a large department store, with whose officers I was in close touch, had purchased this promotion stock. Many of them said they had been persuaded to do so by the representation that the general manager of the store had "invested" $5,000 in the scheme. The stock salesman always gave this information in strictest confidence; so none of the victims ever verified the statement by asking the manager himself. It is curious that it did not occur to anyone that, if the representation was true, the stock salesman who made it was violating the confidence of his customer; and hence was giving proof of

his unreliability. Always remember, therefore, that information of this sort given "in confidence" is a danger signal. I have known one or two cases where young bond salesmen employed by first-class houses have, through ignorance or over-eagerness to make a sale, done this sort of thing. Needless to say, I recommend that such salesmen, and their houses also, be added to your black-list.

Testimony of the Amateur

Sometimes this is done in a direct and much more forceful fashion. By one means or another the promoter hoodwinks well-known persons into giving *written endorsements* of his proposition. As Edgar D. Jones puts it:

> "The most expert efficiency engineers and cost accountants would not be drawn into making any sort of comprehensive statement after such a cursory inspection; but a group of innocent grocers and school teachers and farmers will follow a carefully prearranged path through a plant of a business of which they know nothing and will then draw up resounding phrases of endorsement from the plenitude of their ignorance."

It has also happened that prominent men have lent their names to promotions in return for free stock. Happily the result, more often than not, is that they lose their good names and the stock proves worthless. The thing to remember is that legitimate finance *never* employs the testimony of any but experts; while the illegitimate almost invariably uses that of the *amateur*.

CHAPTER XI

Earmarks of the Fraudulent Promotion

(Continued)

The Guarantee Company — High Sounding Titles—Faith in Names—Real Estate Promotions — The American Booster Spirit — Home Industries — Customer Ownership — A High Price in Trade—Blue-Sky Stocks as Speculations

AN ingenious scheme which is sometimes used to sell promotion stocks is the organization or employment of a separate Guarantee Company which guarantees the return of the full amount of your investment at the end of a specified period, generally twenty years, irrespective of the success or failure of the promotion company. The plan is simply this: when you purchase the promotion stock a certain portion of the purchase price is paid into the Guarantee Company where by the operation of compound interest it will equal your entire investment at the end of the specified period. The balance of the purchase price goes into the promotion company. The utility of the scheme to the promoter lies in the fact that it leads the victim's mind away from a consideration of the risk or worthlessness of the promotion stock; hence makes the sale easier. The Guarantee Company may be perfectly sound and the idea may be applicable to legitimate finance; however, I have rarely seen it used except with promotions.

One must be exceedingly simple-minded and

unwary to be taken in by another trick which is constantly employed, and hence is probably often effective. This is a *company's guarantee of its own securities* or the dividends on them. Is it necessary to explain that such a guarantee is the plainest possible evidence of deceitfulness? There is no magic about the word *guarantee*. Would your own guarantee of your own note add anything to it?

The *high-sounding title* is another type of camouflage. Suggestions of magnificence, boundless wealth, and great security are woven into the grandest of corporate names. "The Sterling Debenture Corporation" (which many of my older readers sorrowfully remember), "The Redeemable Investment Company," "The Northwestern Fiscal Agency" are mild examples.

The Unconscious Speculator

It is absolutely impossible, at the start, to convert a speculation into an investment. Time and the development of a steady earning power alone will do that. Every project, at the beginning, is a speculation, and all its securities, in whatever form, are bound to be speculations. This applies to first mortgage bonds as well as to preferred and common stocks. It is very important to understand this thoroughly.

The most foolish of all the mistakes in finance is that of the unconscious speculator. He means to be, and believes that he is, conservative and prudent, and all unaware of the risk he assumes,

he pursues a dangerous policy with perfect complacency until the shock of failure strikes him. The error is often to be traced to too great *faith in names and titles*. The phrase "First Mortgage Bond" seems incompatible with anything but absolutely perfect security. But, as a matter of obvious fact, a first mortgage bond issue may be secured on anything from blue-sky and undrainable swamps on up. And it takes a very superficial type of judgment to be guided by the mere title. This should merely suggest the query, "first mortgage on what?" and this in turn should inevitably lead on to further investigation of earning power and record.

Real Estate and Building Promotions

Real estate and building promotions are almost always financed by first mortgage bonds. By inflating the appraised valuation and padding building costs, a promoter can very easily make a first mortgage bond issue on a building or apartment appear to be secured by a property which is worth 50% more than the amount of the bond issue, when, in reality, it is intended that the bond buyers shall put up all the real money that is to go into the proposition. I have even known of cases where the amount of the first mortgage bonds was more than the total cost—the excess being a cash profit for the promoter.

It is because this sort of thing is frequently done that I have insisted that real estate securities should be judged in *exactly the same way* as

other corporation securities; that is, on the basis of *proved earning power.*

The bond buyer who puts his money into a first-mortgage bond on a new, and therefore speculative, enterprise, is likely to find himself in this position: if the project succeeds, he will get his money out and a fixed rate of interest, and the real profit will be made by the promoter and the common stockholder; if the project fails, the bond holder, who put up the money, will be the real loser, and the others will suffer disappointment only.

It ought to be plain that it is not good business to let someone else speculate with your money unless he is willing to put in dollar for dollar with you and will share not only the losses but also the profits. And at that, even on a fair basis, the thing is still a speculation and not an investment.

The American *booster spirit* often proves very helpful to the promoter. He usually utilizes it in this way: a proposed factory is to be located in one of two or three different towns. The promoter makes it plain that he will select the town which will give him the greatest support in financing his enterprise; thus he enlists the endorsement of the local Chamber of Commerce and possibly the banking interests in the chosen town and tries to make the average citizen feel that he must buy his share of the securities of the new factory as a matter of civic pride and duty. This plan is employed most often in small and growing cities where the booster spirit is strongest.

Distance Lends Enchantment

There are times when "far fields look fairest" to the investor, and the mines of Idaho, the oil fields of Mexico and the acres of Florida look better to him than anything at home. But this is mainly when the speculative fever is sweeping the country. For the most part, particularly when the conservative mood is on him, it is the *home industry* which attracts him most. If he can see with his own eyes a building, a factory or a store, or knows by sight a promoter, director or officer of a company, no other facts seem to be necessary to prove to him that he is in touch with a sound investment. This is, of course, often used to get his money. Mention was made, in the preceding chapter, of a certain chain department-store promotion. Before this business failed, many fine, new store buildings were put up all over the country. In the cities where these new stores were located, the stock salesmen reaped their richest harvests.

Customer Ownership

Within the last few years many public utility companies have conducted what is known as "customer ownership campaigns," having for their purpose the sale of stock to customers. The idea is that friendly relations between the company and its customers are promoted if the customers become stockholders; and, for companies whose rates and charges are regulated by public authorities, it is considered somewhat of a protection

against unfair legislation and regulation if the stock is widely distributed among voters. This is undoubtedly a sound and wholesome development in finance. It should not be necessary to say, however, that such stocks should be judged by exactly the same standards as other investments. The fact that you buy heat from a company is no proof that the company's stock is a safe investment.

As a general rule, with the exception just stated, you should look askance at the *company which sells its own stock* direct to investors. The reason for this is simply that this is a method of illegitimate rather than legitimate finance. Any really sound stock or bond issue can readily be sold as a whole to legitimate investment dealers, and this is the course which sound-company managers always take. This is one of the reasons why I have insisted so strongly on the necessity of buying securities only through first-class investment bankers.

The Victim Who Gets the Best of the Promoter

Something-for-nothing is, of course, one of the promoter's favorite lures. One method of using it is to make the victim believe he is getting a very high price for property of his in trade for the promotion stock. If he once becomes convinced that he is really getting the best of the promoter, nothing can stop him from swallowing the bait. I heard of a farmer recently who traded land which he knew to be worth about $2,500 for

$5,000 par value of stock. He thought he was really selling his land for double its value; but, in fact, as the stock was worthless, he sold the land for nothing.

To top off the series of warnings in the preceding paragraphs let me say that NEVER, *in all my experience, have I known or heard of a single, solitary business success, where the original capital was raised by the methods I have warned you against.*

"New enterprises are never investments." If you adhere strictly to this fundamental proposition stated in a former chapter, you need pay but little heed to the warnings of this chapter, for this is the financial filter which will not pass 99% of the risky securities you are urged to buy. Frequently, however, these promotions are offered and accepted in the guise of speculations rather than investments.

Promotion Stocks as Speculations

I shall have something to say about speculation later on in this book. Legitimately it has very important and beneficial functions to perform in our modern economic system. You will find the matter treated in any of the great works on economics. I trust that I may rely on the commonsense of my readers to realize that speculation comes *after* investment; that no man, however clever, should indulge in speculation until his investment fund has reached a size to make him and his family safe against the exigencies of life. I

know a few successful speculators, but not one who does not devote his entire time and work as hard at the business of speculation as the average man works at any other business. Speculation is not gambling; it is dealing on the basis of knowledge and study. The speculator is very foolish if he does not confine his speculations to markets which are honestly conducted, where reliable information concerning the things dealt in is readily accessible, and where he may speculate for the fall as well as the rise. Without going into this matter further let me say that only the things dealt in on the great commodity and security exchanges meet these requirements. No blue-sky promotion or penny oil stock ever does.

Chapter XII

Blue-Sky Laws and Taxes

The Modern Way of Preventing Investment Losses — Taxes and the Individual Investor — Taxes and Safety — The "Forgotten Man" — Blue-Sky Commissions — Information about Taxes

THIS whole program which I am advocating necessitates some care and study and the exercise of intelligence on the investor's part, to the end that he may become self-reliant and fully able to recognize and to avoid those financial risks and temptations which wreck the investment policy of the ordinary man nine times out of ten. This is not the modern American way of doing the thing, but I am convinced that it is not too difficult for the average person and that it is the only safe and sensible course to pursue. The modern American way of doing the thing is to pass laws and establish commissions to prohibit investment losses.

These blue-sky laws and blue-sky commissions have a two-fold effect. In the first place, they must be supported by increased taxation, and this is a thing which is directly related to the security of every form of investment. In the second place, the great majority of persons, who retain a childlike faith in the efficacy of laws and commissions to cure evils of every sort, are often made more careless and more unwary by their reliance on

blue-sky legislation. Kirshman makes the point that to judge an enterprise safe simply because it has been passed on by a state commission is "as unwarranted as it is common."

The habit of mind behind this tendency is one of the most alarming and dangerous developments of these times. It is one of the potent causes of the gross extravagance and inefficiency of our national and state governments, and hence of the growing burden of taxation.

Taxes and the Investor

This matter of mounting taxation is of the utmost importance to every investor. First of all, the various taxes he must pay on his investments determine the net yield of these investments, and the inheritance taxes reduce the value of his estate. Under certain circumstances they may take it all. Graduated federal income taxes make the tax burden so great for persons with large incomes that tax-exempt bonds are absolutely the only kind of investment securities which such persons can purchase. This makes the investment problem very simple for the rich, but it is a very serious matter for the economic life of the country as a whole; for it encourages municipal extravagance and, by stimulating the demand for tax-free bonds, reduces tremendously the funds available for legitimate industry.

Every individual must also study the relation of his investments to local taxes. The whole problem is quite complicated and varies widely

with different circumstances. I shall not consider it further than to emphasize the fact that it must be given careful attention. As I have elsewhere indicated, this is a matter on which the investment banker may be very helpful. Increasing taxation, together with increasing state and municipal bonded indebtedness, has a bearing also upon the inherent *safety* of every form of investment.

History shows very plainly that, for every community, there is a limit beyond which the tax rate may not be increased. When this limit is passed, taxes are simply uncollectible. Under our laws all the municipal bond issues of a community are equally secured. Hence it is plain that as taxes and bond issues increase, the safety of municipal bonds, at least theoretically, decreases. Likewise earning power, that fundamental basis of investment, in every possible field is reduced by the expense of taxation; and so the safety of investment in every type of business enterprise is affected.

Moreover, these taxes increase all living costs, the prices of all rents, commodities and services, so that the net amount which any individual may save out of his earnings is substantially reduced thereby, as well as by the amount which he pays out directly in taxes. This is a matter which every citizen should understand, but it is of particular importance to investors, savings-account holders, home owners and all those who are saving money and putting it to use in whatever way.

The Forgotten Man

If I visualize my readers correctly, a large proportion belong to that great class of which Sumner named the individual member the "Forgotten Man." He says,

> The type and formula of most schemes of philanthropy or humanitarianism is this: A and B put their heads together to decide what C shall do for D. The radical vice of all these schemes, from a sociological point of view, is that C is not allowed a voice in the matter, and his position, character and interests, as well as the ultimate effects on society through C's interests, are entirely overlooked. I shall call C the Forgotten Man. For once let us look him up and consider his case, for the characteristic of all social doctors is that they fix their minds on some man or group of men whose case appeals to the sympathies and the imagination, and they plan remedies addressed to the particular trouble; they do not understand that all the parts of society hold together, and that forces which are set in action act and react throughout the whole organism, until an equilibrium is produced by a readjustment of all interests and rights. They therefore ignore entirely the source from which they must draw all the energy which they employ in their remedies, and they ignore all the effects on other members of society than the ones they have in view. They are always under the dominion of the superstition of government, and, forgetting that a government produces nothing at all, they leave out of sight the first fact to be remembered in all social discussion — that the state cannot get a cent from any man without taking it from some other man,

and this latter must be the man who has produced and saved it. This latter is the Forgotten Man.

Taxation Is a Social Evil, Not a Panacea

Taxation in itself is one of the greatest of social evils, for it takes away from the "Forgotten Man" the just rewards of his industry and thrift. The only proper purpose of taxation is to meet the expenses of government. This is plain common sense, but there is another insidious socialistic theory which is beginning to force its way into our system of taxation. It holds that it is a proper object of taxation to attempt a redistribution of property and a leveling of incomes. Thus wealth and success are penalized by graduated tax rates, and every effort to reduce taxes is opposed because the rich may benefit. All experience in this country is to the effect that taxes, once imposed, are well-nigh impossible to remove or reduce. Moreover, more than half the voters of this country never see a tax bill of any kind. Naturally they are more inclined to favor increased taxes than otherwise, and the average politician's interest seems to lie in the same direction. But these taxes levied on the wealthy and the big corporations are in reality, to a large extent, indirect in ultimate effect, raising prices and living costs and reducing the available jobs. And as Lasalle says, "The indirect tax is a tax on labor."

Put Not Your Faith in Blue-sky Laws

One of the results, or perhaps one of the causes,

of the growing burden of taxation is the great increase in political jobs. Public employees and pensioners now number one-twelfth as many as all the persons engaged in gainful occupations and one-seventh of total national income goes to the expenses of government in the form of taxes.

Far too many of these jobs are of the blue-sky commission type. Within recent years nearly every state in the Union has organized a blue-sky commission. During the same period the losses which the public has suffered from fraudulent promotions have been greater than ever before in history. I do not deduce from this that the establishment of the commissions has caused the other; but it is a fair assumption that the commissions have done little to protect the public. And how could it be otherwise? The crooks always have been, and always will be, about three jumps ahead of the law. Moreover, the type of politician who is bound to be appointed to these commissions scarcely ever is a sound business man with any experience of investments of any kind. When it was proposed in Congress to place the issuance of all securities in the United States under the supervision of the Federal Trade Commission, which should be required to pass on the soundness of the proposed issues as investments, Sturgis, author of *Investment, a New Profession,* said, "Would it be possible to propose anything worse for the investor or the country than to have a governmental body, swayed by politics, pass upon the soundness of investments?"

The moral of these few pages for the investor is plain—put not your faith in blue-sky laws and commissions; throw your weight against increasing taxation.

All the information which the average investor needs about income, inheritance and local taxes in relation to his investments may be obtained from the pamphlets on the subject which are distributed free by many banks and bond houses. Taxation is a subject on which the investment banker must be informed, especially in respect to its incidence on the different types of securities, and his customers may consult him without expense. Difficulties which may arise in the making out of tax returns, the settlement of estates, etc. should, of course, be referred to a lawyer.

Chapter XIII

Business Prophets and Seers

Diversification — Continuous Investing — Forecasts of the Business Cycle—Fundamental Fallacies—The Investor Must Particularize

INSURANCE companies are among the largest and most experienced investors in this country. A study of the investment holdings of these institutions naturally reveals that some favor railroad bonds; some, municipals; some, city mortgages; some, farm mortgages; and some, public utility and industrial bonds. In a few cases there are large holdings of investment stocks. In spite of the preferences which the individual companies show for certain fields of investment, practically all hold to the general principle of diversification and, so far as they are permitted by law and their charters, scatter their investments both geographically and categorically. This practice is obviously so sound and is emphasized so frequently in investment literature that I shall do no more than mention the fact that it is a good rule for investors of any kind.

There is another rule which insurance companies have developed out of their long experience, and I have never known of a really big insurance company which did not hold to it. The rule is to invest funds as soon as they accumulate—irrespective of market conditions, high money rates or low, good times or bad, hunches, forecasts, or

tips. I regard this as being a highly important and valuable rule for the individual investor also. I am going into it because much of the current financial writing and several of the text-books I have referred you to rather advise an opposite course.

The Favorite Magic of This Enlightened Age

Every age has its favorite magic, its pet fallacies and delusions. In these days, in the business and financial world and in the field of academic economics, faith is fastened on charts, statistics, and forecasts of the Business Cycle. The belief is that it is possible to predict business depression, prosperity, the course of bond and stock prices, the ups and downs of interest rates, and the movement of commodity prices. A considerable amount of really scientific and valuable work has been done in the compiling and correlating of business statistics and their construction into graphic charts which give a remarkably vivid picture of certain phases of business history. Those students of these matters, however, who are best grounded and most intelligent, are very conservative and cautious about making any claims whatever for the *predictive* value of their work, especially as applied to bond and stock prices.

On the other hand, there is a fairly large group of semi-professional economists who, for financial, not scientific, reasons, are exploiting the idea of the Business Cycle and who make quite extravagant representations regarding their infallibility

as forecasters of bonds and stock prices and of general business conditions. Their arguments and charts are so perfectly plausible that even the most experienced are likely to be taken in.

Here are a few of the points in which all these forecasting systems are particularly vulnerable. The concept, Business Cycle, is that of a series of developments which constantly repeats itself and of which the various phases, "prosperity, liquidation, depression, recovery," invariably succeed each other in a regular order; this makes it possible in any phase of the cycle to predict what the next phase will be. Without going into the matter further or giving the numerous examples in experience which prove my case I will say that this assumption, that the cycle repeats itself over and over in exactly the same way, is absolutely without foundation in fact.

In the next place, all the forecasting charts and indices are based on the theory that it is possible scientifically to combine unlike units. The commodity-price index, for example, which is one of the most important of these indices is made up of such factors as prices of oil per barrel, cloth per yard, coal per ton, wheat per bushel, etc., etc.,—a thing which every schoolboy knows is logically impossible.

Thirdly, none of the forecasting systems pretends to include all the factors affecting economic conditions. In fact, the most influential and powerful factors, such as war, international finance, foreign and domestic politics, tariff laws,

developments in currency systems, are actually always left out. Professor Jordan enumerates nine important factors which are left out of consideration by that forecasting service which, at this writing, enjoys the best reputation in this country, and he adds that *"business conditions are susceptible to the influence of so many factors that it is quite impossible to resolve them all into any contrivance that will automatically foretell future economic developments."* It is interesting also to know that two hundred and thirty-two different answers to the question, "What causes the Business Cycle?" have now been listed.

Lastly, omitting a number of other criticisms for the sake of brevity, the concepts, "general business," "the stock market as a whole," "the bond market," have practically no relation to any *particular* business or any *single* stock or bond. The idea, "general business," is of the same character as that of "normal weather." For the latitude and longitude in which this is being written, normal weather for the first of June is an average, extending over many years, of weather conditions on that date; and an enormous range of conditions, including frost, blizzards, snow, hail, rain, and temperatures from 30 degrees to nearly 100 degrees are all represented. No sensible person would give any weight whatever to this average in attempting to forecast the weather for any particular day. Instead he would use the data used by the Weather Bureau; that is, local and surrounding meteorological conditions as of

the time of the forecast. So also, no speculator in wheat pays any attention to commodity-price indices, but bases his judgment only on those factors which affect the price of wheat directly.

The Investor Must Particularize

The investor always has this problem—he must invest in a particular business, a particular stock, a particular bond. He cannot put his money into "general business," or "the market as a whole," or into any other abstraction. He must analyze each investment on the basis of the factors affecting it. He needs to particularize, not generalize. Regarding the popular generalizations about the Business Cycle, let him remember the saying of the witty French philosopher: "All generalizations are false—including this one."

I have gone into this matter at this length because I have seen so many investors who meant to be careful and conservative led all unwittingly into foolish speculations by these forecasting services. And so with Mead, author of *The Careful Investor,* to which I have referred you elsewhere, I advise you to "avoid the professional stock market educators." Their services when considered sufficiently skeptically have a certain very, very small value for the speculator. For the investor they are useless. I may say here also that this advice is worth consideration by merchants and manufacturers, many of whom I have observed gambling in raw materials or inventories

on the basis of charts and forecasts of "fundamental conditions."

The rule, "invest funds as soon as they accumulate," means *after* they accumulate, not before. In other words, do not borrow to make investments. I have never heard of an insurance company, or of a great bank either, borrowing money in order to take advantage of an investment opportunity. At any one time first-class investments are all pretty much alike. If you miss one, you may be sure of finding another. The investor's main object is to make himself financially safe, and no man in debt can be said to be perfectly safe.

From the investment policy of insurance companies, and I might add of banks too, the individual investor, then, may learn these things: (1) diversify—do not put all your eggs in one basket; (2) invest as funds accumulate—do not speculate for better opportunities; (3) do not borrow to make investments—keep out of debt.

Chapter XIV

Why Investment Values Fluctuate

Investment Prices Based on Value of Future Income—The Standard of Value Fluctuates—Causes of Variations in the General Level of Interest Rates — How Interest Rate Fluctuations Affect Bonds and Stocks

ONE of the most puzzling things in connection with the investment in stocks and bonds is the fact that the market price of a perfectly sound investment may move up or down within quite wide limits. Everyone remembers the great drop in Liberty bond prices shortly after the War and their subsequent rise to a level above their original issue price. And the swings of the stock market are a commonplace in modern finance. In fact, the investment market seems always to be in a state of flux, rising and falling as the tides of the sea do, but without the same regularity.

In Chapter VII it was explained that the valuation of a property of any kind depends fundamentally on the amount of income it may be expected to produce; in other words, on its earning power. Exactly the same principle applies to the valuation of investment stocks and bonds. Essentially the investor, in making an investment, purchases future income.

Under circumstances in which the investors are willing to pay $100 for each $5 of future annual

income we may say that "the general level of interest rates" is at 5%. When this is the case the market value of all sound investments (we are eliminating from consideration the effects of differences in risk and prospects and other minor influences) will be adjusted to yield approximately 5% per annum. Thus a stock paying $5 per share per annum in dividends will be worth $100; one paying $6, $120; one paying $4, $80.

The standard of value for securities, therefore, is the general level of interest rates; that is, what investors are willing to pay for future annual income. But this standard is not a simple, elementary thing; it is an intricate compound of many influences; it is not fixed and invariable, but fluctuates considerably from year to year; and it is recognized as one of the most profound and influential of economic forces.

The Riddle of Interest

What are the factors which cause variations in the general level of interest rates? We do not know them all, or understand them fully—the riddle of interest is easily the most difficult in economics. When business is active, prices rising, prospects bright, and everyone is optimistic and busy, and there is a tendency to extravagance and self-indulgence, the interest rate is high; when times are bad, or are expected soon to be, when men are apprehensive, profits are low, and everyone tends to become careful, thoughtful and thrifty, the interest rate moves downward. It is

evident that mass psychology, the character of the individuals in a population, social and political conditions, even the weather as it influences crops, are fundamental factors in determining the interest rate. Popular ideas on the subject are, for the most part, fallacious. Changes in the per capita circulation of money—that is, in the actual supply of money—affect the interest rate only slightly and temporarily. Regulatory legislation is practically futile, and the popular superstition that Wall Street can shove the rate up or down at will is without foundation. Particularly clear explanations of this subject are to be found in Irving Fisher's *Principles of Elementary Economics* and his *The Rate of Interest.*

The important facts to bear in mind are these: fluctuations in the value which men set upon future income occur; the causes of these fluctuations are many, they are not fully understood, they are uncontrollable, it is impossible to predict their operation.

The rate of interest, in the sense in which I have been using it, is a confusing term. There are many rates of interest—the rates for call money, commercial paper, time money, government bonds, etc. All these rates are different: they are different because they are associated with different risks and different conditions of payment. But underlying them all is the value which men, at any one time, are setting upon future income. This value is *pure* or *implicit* interest. It is what

I have been calling the rate of interest, or the general level of interest rates.

The Effect of Changes in the General Level of Interest Rates

Now let us suppose that an investor buys $5 of annual income for $100. As long as this income is paid promptly and there is no reason to expect it to be reduced or discontinued, the investor is getting just exactly what he paid for. But suppose the general level of interest rates advances to 6%. Then the market value of the stock or bond which he has purchased is bound to decline to a point where it will yield 6%, instead of 5% as at the time of purchase. For a stock, this is $83.33; that is, an investment of $83.33, paying an annual income of $5, will yield 6%.

While the market value of his investment has declined, the investor has really lost nothing; he still has the annual income of $5 which he originally purchased. Nor would he have gained anything had the movement been the other way. It must be recognized that these fluctuations are inevitable; they may be deplored, but they are not controllable and they are not predictable. They are simply in the nature of things and must be accepted.

This, however, is true: the fluctuations of the interest rate are always within limits. It may never decline to zero, nor advance to unity. Practically speaking, these limits in our times, in the United States, may be set at a minimum of

three percent. and a maximum of seven. Almost any point within the limits is likely to be touched more than once in an average lifetime.

Why Bonds Are More Stable than Stocks

The market prices of both bonds and stocks are affected by the fundamental factor under consideration; but under its influence, the prices of bonds fluctuate less widely than the prices of stocks. A fixed annual income, continuing indefinitely, is what the purchaser of an investment stock looks for. In the example given above, a $5 annual income was worth $100 with the general interest level at 5%, and $83.33, with the level at 6%.

A bond, however, is not a fixed annual income continuing indefinitely; it is a fixed annual income for a definite number of years together with the payment of a definite sum at the end of the term of years.

Consider a 5% bond for $100 due in ten years. This means an annual income of $5 for ten years and the payment of $100 at the end of that time. With the general interest level at 5%, such a bond will be worth $100, or par. With the level at 4%, $108.18; with the level at 6%, $92.56. These figures are derived from mathematical tables called "bond value tables." The reason why a $100, ten-year, 5% bond at $92.56 yields 6% is that the holder will receive not only $5 annual income but also, in ten years, $100 in principal, against an original investment of $92.56. This difference between $100 and $92.56, properly dis-

tributed over the ten years and counted as income, increases the yield to 6%.

It is easy to see that nearness to maturity tends to narrow the limits within which a bond may fluctuate under influence of changes in the general level of interest rates. Thus, a three-year, 5% bond at $102.80 yields 4%, and at $97.29 yields 6%; a ten-year bond, as above; and a fifty-year, 5% bond must sell at $121.55 to yield 4%, and at $84.20 to yield 6%. For a stock (which has no maturity) the variation would be between $83.33 and $125.00.

As between two investments, therefore, one a stock and one a bond, for both of which the annual income is equally safe and certain, the stock will be much more "speculative" than the bond; that is, it will fluctuate much more widely in market value. This is a matter which the investor must thoroughly understand. It makes an investment in stocks, particularly a temporary investment, much more risky as respects market value than an investment in bonds.

A Very Common Error

When investors are ignorant of or disregard the fundamental fact that the general level of interest rates fluctuates, they are led into a very common error. Bankers and bond dealers, investors both large and small, all seem to make this mistake on occasion. It is illustrated by this example: the general level of interest rates is at 6%—bonds of the highest type may be bought on

this basis. Everyone gets into the habit of thinking about investments in terms of 6%. Suppose that the general level of rates moves slowly down to 5%. Now first-grade bonds yield 5%, and only second and third-grade bonds yield 6%. All investors who are still thinking in terms of 6% have unconsciously been lowering their investment standards. In order to obtain 6% they have been increasing the risk by buying a poorer class of bonds.

Twenty-five years ago, in the period of low rates which then prevailed, a prominent American banker said that he never expected to see first-class investments yield over 4% again in this country. Predictions on this subject, as I have shown, simply cannot ever be sound. Like many other things in life, the only unchanging thing about the interest rate is that it is sure to change.

The Method of Comparisons Again

It is because the level is subject to change that it is impossible to formulate a general rule, good for all time, to the effect that bonds which yield a certain rate or less are safe, and those which yield more are not.

As I have pointed out in several places, there is only one way to get at the heart of this matter. It is by using the method of comparisons. If the yield of a bond under consideration proves to be materially higher than other similar bonds, it is more than likely not so safe as the other bonds. If conservative real estate mortgages are gener-

ally being made at 6%, it is a good guess that one which is offered at 7% is not conservative.

It is not to be understood that the movements of the general level of interest rates are the only influences which affect the market prices of investments. In discussing the business cycle and variations in the purchasing power of money I have indicated how other factors than the interest level bear on prices. The interest rate, however, is a fundamental factor and may alone account for very considerable price changes. Newspaper writers, who habitually dramatize market movements, generally ascribe the ups and downs to conflicts between the bulls and bears to the manipulations of pools and cliques, and to the operations of well-known individuals. The most careful students of finance, however, are inclined to place little weight on such influences.

CHAPTER XV

Speculation and Investment

Investor Must Disregard Market Changes — Difference between Speculation and Investment—Continuous Investment Equalizes Fluctuations — Why Speculation Is Disastrous — Borrowing and Buying on Margin

AN explanation of the ups and downs of investment bonds and stocks has been given in order to reinforce the argument of Chapter XIII. The perfect investor will recognize that such fluctuations are inevitable. He will forget them, leave them out of consideration entirely, and devote all his attention to the purchase of annual income and a study of the factors which determine its safety and permanency. There is always the danger, and this is what I mean to warn you against, that the fluctuations of the securities market will lure the investor into the speculative attitude of mind. The essential difference between the speculator and the investor is that the first has his mind on changes in market prices, while the latter looks to fundamentals.

Obviously for the investor who makes it his policy to invest funds as soon as they accumulate, year in and year out, those fluctuations in market prices of the type under consideration tend to be equalized. He will buy at low levels as often as at high. This policy, as stated in Chapter XIII, is followed by all large insurance companies and

banks and is the only safe course for the individual investor also.

On the other hand, the average speculator who is deluded with the idea that it is possible to predict the ups and downs almost invariably fails. He is truly a "lamb." He rarely gets the benefit of the equalizing of high and low prices which the steady investor receives; because the speculator characteristically is in and out of the market spasmodically. Ordinarily he is absorbed in his own business and does not make up to an advancing market until the movement has progressed far and become spectacular and the subject of newspaper comment; then he scrapes together what money he can, buys on margin, and suffers a loss when the market turns. Or, if he has bought at a high price and holds on, he generally does not notice the market until it has declined considerably; then he becomes convinced that the decline will continue indefinitely, and sells out his holdings as the market is reaching bottom.

The Economic Function of Speculation

Speculators collectively perform an important economic function. Their operations tend to stabilize markets and at times even prevent complete demoralization. It is my observation, however, that probably ninety-nine out of a hundred individual speculators lose more money than they make. And this is why I have taken pains to show, in previous chapters, that the factors which determine the development of the business cycle

and the fluctuations in the general level of interest rates and which, in turn, are behind the up and down movements in the prices of securities, are intricate, involved, uncontrollable, and wholly unpredictable.

There seems to be a gambling or speculative streak in the character of most people. The individual who recognizes that he has this and who cannot control it should limit his investments to the non-fluctuating variety, small real estate loans running not over five years, insurance, and short-term bonds. He should avoid long-term bonds and stocks as these are more subject to fluctuations in market price; and hence are likely to tempt him into the speculative attitude.

A few years ago a customer of mine sold out his business and had $100,000 to invest. I recommended a list made up half of bonds and half of investment stocks. After I had explained my recommendations, particularly of the stocks, he said, "I think your plan is perfectly sound, but I am afraid to buy stocks. I will get to speculating if I do. I have had experience enough to know that it is easy for me to catch the fever. So I am going to stick entirely to bonds." Under the circumstances this seemed to me to be the height of wisdom.

Borrowing Leads to Speculating

The speculative attitude of mind is frequently evidenced when an individual goes into debt in order to buy securities. In fact, there is hardly

ever any motive behind borrowing for this purpose except the belief that the price of the securities in question is lower at the time of purchase than it will be in the future. In other words, the borrower has achieved the common delusion that he can beat the market.

The commonest method of borrowing to buy securities is buying stocks on "margin." This is an arrangement which may be made with a stock broker under which a purchaser pays down only a fraction of the cost of a stock. The broker finances the balance of the purchase price and holds the stock as security for this amount which becomes, in fact, a debt of the purchaser. Interest is charged against the purchaser, and he must also agree to protect the broker by maintaining his cash margin at a certain proportion of the market value of the stock.

For example, the purchase of ten shares of stock at $100 per share requires $1,000 if the purchase is made outright; that is, if the stock is paid for in full. On a "twenty-point margin," however, the same number of shares may be bought with $200; or, 50 shares may be purchased for $1,000. Suppose an investment of $1,000 is made by the purchase of ten shares outright. If the market price of the shares advances to $105 or declines to $95, the profit or loss is accordingly $50. But if $1,000 is put up as margin for the purchase of 50 shares, a 5% advance or decline will make a profit or loss of $250 or 25%. Thus it may be seen that the real effect of borrowing

is to multiply the influence of variations in market value; in other words, to increase the risk. The investor who borrows is taking a long step toward speculation.

Chapter XVI

Stocks as Investments

Relative Investment Position of Stocks and Bonds—Judging Stocks—Variations in Purchasing Power of Money—Reinvestment of Undistributed Earnings — Preferred Stocks — Taxes —Much More Required of Investor in Buying Stocks

IT might be thought to be consistent with the general plan of this book to eliminate stocks from the field of investment altogether. Many financial writers do this, "Bonds are investments, stocks are speculations," they say. There is undoubtedly more risk in buying stocks than in buying bonds, and, as the primary purpose of this book is to indicate ways of avoiding risk, I should advise against the purchase of stocks except that I believe this would be unsound and sometimes disadvantageous, and I am convinced that there is something in the claim that stocks are entitled to serious consideration from the investment standpoint.

In Chapter XIV I have explained why stocks are subject to much wider fluctuations in market price than bonds are and have pointed out why these fluctuations often lead investors in stocks into the speculative attitude of mind. It must be understood also that, in general, stocks are not so safe investments as bonds. To make this clear, let us consider:

THE EXAMPLE MFG. CO.

CAPITALIZATION

Common stock (10,000 shares of $100 par value)	$1,000,000
Preferred Stock (7% Cumulative)	300,000
First Mortgage Bonds (6%, due 1935)	200,000
Total Capitalization	$1,500,000
Average annual earnings available for interest, dividends, etc.	$200,000
Cost of plant and real estate on which bonds are a first mortgage	500,000

Taking the bonds first, we note that they are secured by first mortgage on property which cost two and one-half times the total issue. Annual interest on the bonds amounts to $12,000 and earnings available to pay this are more than fifteen times the requirement. Dividends on the preferred stock at 7% have the next claim on earnings; the requirement is $21,000 and it is covered about nine times. The preferred stock is not secured by mortgage on any particular assets; it is entitled simply to dividends at 7% before any dividends may be paid on common stock, and, in case of sale or dissolution of the corporation, is to be retired in full at par before any distribution may be made on the common stock.

After interest and preferred stock dividends are deducted there remains $167,000 available for dividends on the common stock. A dividend of 8% would take about half this amount and conservative practice would require the investment of the balance back in the business. Now if

experience has shown that the earning power of this corporation has been steady over a period of say ten years with a tendency to increase and the 8% dividend on the common stock has been regularly paid with a good margin to spare every year, we may consider that the common stock is in the investment class, as well as the preferred stock and the bonds which obviously belong there.

But, in spite of the fact that all three classes of securities are to be regarded as investments, there is still a wide difference in their relative safety. Observe how far the earnings may decline and still show a margin over the interest required by the bonds.

Choosing Between Bonds and Common Stocks

The relative position of the securities of the Example Mfg. Co. is very easy to arrive at, but the difficulties of analysis are increased when a choice is to be made between the first mortgage bonds of one company and the common stock of another. The true criterion, as was explained in Chapter VII, is the earning power, its amount, stability, and history, and the extent to which it exceeds interest or dividend requirements. It sometimes happens that the common stock of one company is actually a safer investment than the first mortgage bonds of another.

The general principles on which the investor should rely in considering stocks are much the same as for bonds, except only that the standards must be higher and the requirements much

stricter. As Professor Huebner says, "The intrinsic values of stocks and bonds must be ascertained by much the same methods of analysis."

Safety of principal and regularity of income are the first considerations. These are to be ascertained by the record, with particular emphasis on the record of earnings. Five years of satisfactory earnings may pass a bond, whereas ten, fifteen, or twenty years should be necessary to put a stock in the investment class. That an uninterrupted dividend record for a long period is a requirement it is hardly necessary to add.

To bring out points of weakness and of strength and as a general, all-around check, compare several companies of the same kind together. In comparing six or eight stocks of similar companies you will generally find that the majority of them yield practically the same. One or two may yield considerably more than the average. As has previously been explained, these are the ones *not* to buy. There are always reasons for high yields and, more often than not, they are to be regarded as danger signals.

In the purchase of stocks it is difficult to avoid the speculative attitude of mind. But this is absolutely essential. To predict the course of the stock market, even to say when stocks are high or low, is unquestionably impossible. The thing to do is to disregard the speculative factors entirely and devote every faculty to a thorough study of individual investments.

There are a number of railroad, some public

utility, and a few industrial stocks, which will pass the most rigid investment tests. You will perhaps be surprised to find that the yield to be obtained from such stocks is, on the average, little or no higher than that of first-class bonds. But there are two advantages which are claimed for investment in stocks which may not be had by investment in bonds and these reasons are, I think, sufficiently weighty to merit serious consideration.

Risk Due to Fluctuations in Purchasing Power of Money

In the first place, every investment involves some risk in connection with fluctuations in the purchasing power of money. If you buy a $1,000 bond due in ten years and during that period the cost of living rises sufficiently, you may find when you collect the $1,000 in cash called for in the bond that this sum will buy so much less in commodities that, in spite of receiving your interest and principal promptly and in full, you are considerably the loser in the transaction. When the cost of living is rising, of course, the purchasing power of money is declining. A rise in commodity prices not only reduces the value of the principal of an investment but diminishes the purchasing power of the interest or income as well. On the other hand, if prices fall during the period of an investment in bonds, the bondholder gains instead of losing.

Now it is necessary to realize that for a long time in this country commodity prices have either

been moving one way or the other, up or down. From the close of the Civil War until 1897 they fell quite steadily. From then until 1920 there was a great rise, followed by a sharp fall and another rise. Investors in bonds during the earlier period profited steadily. But during the last twenty-five years or so they have been the losers.

For example, an investor who bought a 25-year 4% bond at par in January, 1900, (this is a fair example because this was the best rate obtainable on good bonds at that time), collected his principal in January, 1925. The U. S. Department of Labor Index of Wholesale Prices stood at 80 in 1900 and 160 in 1925. This means that in 1925 prices were just double those of 1900; in other words, the principal received by our imaginary investor would buy just half as much.

What the Authorities Say

This is a matter which has received considerable attention from economists and financial writers. Irving Fisher in *Stabilizing the Dollar* is particularly interesting and instructive. He proposes to solve the problem by introducing modifications of our currency system designed to prevent fluctuations in the general commodity price level. It has also been proposed to make bonds payable in terms of commodities instead of dollars. This device was actually used in Germany during the paper-money inflation after the war. Most of the writers on investments ignore

the difficulty altogether. Kirshman in *Principles of Investment* says, "While such changes in purchasing power undoubtedly are continually working injury on investors, it is notwithstanding impracticable to take account of this factor in connection with safety."

On the other hand, Sturgis faces the thing squarely: "Under the heading of general conditions alone we have to-day a number of questions of extreme importance. For instance, the United States holds nearly 50% of the world's gold. Here is a fundamental condition which will probably affect in some manner all our securities. . . . The gold we have is well beyond our needs as a reserve for our currency . . . and there never has been a time when this country has not made use of its available credit resources when business was favorable. Since they are more than is needed is anything going to prevent another period of inflation? This is really one of the fundamental questions of the day as far as securities are concerned; for, if there is to be inflation, it is quite inevitable that fixed income bearing securities should go down, and stocks of companies which will profit by rising prices should go up."

Van Strum's *Investing in Purchasing Power* is an able, interesting, and understandable investigation of this matter.

The Practical Answer

There is, in fact, only one practical answer to

this important problem. No one can predict the rise and fall of commodity prices; and, at the same time, these fluctuations are certain to continue. The investor who makes investments in both bonds and stocks has insured himself, so far as it is possible, against whatever movement in prices may take place. Bonds are payable in dollars, and, if prices decline, dollars are worth more. Stocks represent an interest, a sort of partnership or ownership interest, in properties and business enterprises and, if prices rise, property values and business profits generally do also, and these in turn mean larger dividends to stockholders and higher stock market prices. This is the first reason why stocks should have consideration as investments, as well as bonds.

Compounding Undistributed Earnings

The second reason is quite convincingly treated in Edgar Lawrence Smith's *Common Stocks as Long Term Investments.* It is the general tendency of the stock of conservatively managed companies to increase in value through the reinvestment of surplus income in the business. It is not good business practice for a corporation to pay out in dividends all that it earns. All the earnings, of course, belong to the stockholders, but only a part are paid out in dividends, the balance being retained in the business. In this way the earnings not paid out are reinvested in the business, or compounded. This is illustrated by the case of the Example Mfg. Co. which was stated

at the beginning of this chapter. Of total earnings amounting to $200,000, bond interest required $12,000 and preferred stock dividends $21,000. This left $167,000 available for dividends on the common stock. The 8% dividend required $80,000, and $87,000 was carried to surplus and reinvested in the business. From the stockholder's standpoint this essentially meant that his investment in the common stock of the company had earned 16%, of which half had been paid to him in cash and the other half invested for him. The latter half he might regard as being partly in the nature of insurance against emergencies which might operate to diminish the earning power of the company, and partly as an investment from which he might expect eventually to obtain increased dividends.

The practice just illustrated is one which should be followed by all conservatively managed corporations.

Preferred Stocks as Investments

What has been said so far in this chapter refers to common stocks only, not to preferred stocks. As a general rule, the dividends on preferred stock are limited to a definite rate, just as bond interest is; hence the investor in preferred stocks may not expect his dividends to increase if commodity prices rise and the earnings of his company increase. His investment, however, at least theoretically, is made safer by the practice of carrying part of the profits to surplus. Broadly

speaking, it is proper to regard preferred stocks as debenture bonds without maturity. *Debenture* bonds are bonds which are not secured by a mortgage or a lien on any specific assets; that is, they rank as unsecured notes. Most modern preferred stocks are cumulative, preferred as to assets and dividends, and many carry sinking-fund provisions which tend to stabilize the market, and, as a rule, operate to retire the issue at a premium. Thoroughly seasoned preferred stocks are often very safe and attractive investments. They should be analyzed by the same methods as bonds, but much more carefully.

Another point to be considered with stock investments is the question of taxability. This is a matter which every individual must study out for himself. It is impossible to give general rules or specific directions because federal and state tax laws are being constantly changed, the laws of the various states are widely different, and the principle of graduated taxes as applied in income and inheritance tax laws makes the tax rate for each individual dependent on the size of his income or the value of his estate. It is necessary for the investor to find out to what extent the state in which he lives taxes various types of stocks and bonds; what rate of federal income tax a person of his income must pay, and how this affects the income from investments; and what inheritance taxes must be paid by his estate in the event of his death. As I have previously stated, the handiest

source of information on these questions is the investment banker.

Inheritance Tax Difficulties

At this writing, inheritance tax laws are particularly involved, and often quite unfair to stockholders as compared with bondholders. The federal income tax law, on the other hand, favors stockholders as against bondholders, as it exempts dividends from the normal tax and makes stocks in the hands of a corporation entirely tax-free. State tax laws vary widely. In most cases the stocks of companies chartered in a state are not taxed by that state, but stocks of companies chartered in other states are. In one state, Colorado, all stocks, domestic and foreign, both common and preferred, are tax-exempt except for inheritance taxes.

The investor must depend a great deal more on his own judgment in purchasing stocks than is the case with bonds. Moreover, there is more risk in stock investments; the fluctuations in market value are greater; the temptation to speculate is stronger; the analysis of stocks must be carried further than is the case with bonds; in every direction much greater care and judgment must be exercised. Therefore in spite of the possible advantages which have been indicated, no investor ought to enter the field of stock investments until, by study and experience, he has made himself a thoroughly competent judge of investment values.

Chapter XVII

The Common Faults of Investors

Timidity — Carelessness — Speculation — Successful Investment Possible for Any Man or Woman

As a bond dealer who has had to do with a great many investors, large and small, experienced and inexperienced, it is my observation that there are three great faults which are more or less common to all. These are timidity, carelessness and speculation.

For the most part, it is the small and inexperienced investor who suffers from timidity. Because he is prone to feel that his business is not important enough to receive attention from the largest banks and bond dealers, he is much more frequently the victim of the fraud or incompetence of others than the large investor is. This feeling alone must account for the loss of many millions of dollars of savings annually. I know it is very widespread.

At the same time, I know positively that, in these days, it is wholly without foundation. One of the most important points I have tried to make in this book is the fact that the largest banks and the largest investment houses welcome the "little fellow." They want his business because they have recently discovered that it is of the greatest economic and financial importance. And because it is profitable. Small savings accounts make up a

big share of the total savings of this country, and there is hardly a large and successful bond dealer who does not consider his smaller customers the backbone of his business.

Carelessness of Investors

Carelessness in financial affairs is certainly a national characteristic. "A chief cause of the troubles which arise in operating a business," says Jones in *Investments,* "is lack of thoroughness in the mastery of the essential factors in any situation. Similarly, a lack of thoroughness in investment is the prolific mother of losses."

Only those who have actually had experience in selling investments are likely to be able to appreciate the extent to which all sorts and conditions of investors are habitually careless. One of the first lessons a bond salesman learns is that most of his customers will not listen to facts or thorough analysis. The best type of bond salesman knows a great deal about investments, but he is frequently forced, by the attitude of his customers, to employ much the same methods to make sales as those found successful by the blue-sky peddler. He must use human interest, exploit his own personality, study the whims of his prospect, excite his cupidity, and finally rush him into closing the sale. And he often finds that the less he has to say about the really essential facts the greater his success. Large investors are to be handled in this way, just as frequently as small.

This is one reason why I have insisted so

strongly on the wisdom of transacting financial business only with the best institutions. It is why I advise the investor to develop the habit of going to the bond dealer's office when he is ready to invest. And it is why I advocate his making certain investigations and applying certain tests himself. One who does these things will avoid hasty action; he will base his decisions on essentials, not unessentials; and he will escape the temptations of all kinds of financial agents and schemers.

The Tendency to Speculate

As to the tendency to speculation, few men are without it. It is the universal desire to get something for nothing. I have explained the fundamental reasons why securities fluctuate in market value and why these fluctuations are unpredictable; why, therefore, speculation is not only dangerous but almost certainly disastrous. There is no touchstone for successful speculation. The forces which cause fluctuations in the market prices of securities are too involved, too diverse, and too little understood to make such a thing possible. For bonds and stocks of true investment standing, the variations in prices, while inevitable, are within limits and may be equalized by a policy of continuous investing. The investor should accept market fluctuations as being in the nature of things; he should disregard them; and give all his attention to the analysis of individual investments, a field in which his efforts will be well rewarded.

Successful investment is something which any man or woman who proceeds along the right lines may easily achieve. It has never been so easy as it is today. Sound banks and safe investments are accessible to everyone. Only a few simple precautions, a few easy and definite investment standards, and the understanding of two or three basic economic principles are necessary.

THE END